

The collateralised loan obligation market is currently a shadow of its former self, but, as **Peter Gleysteen** of CIBC writes, the argument for making these instruments the mainstay of investing is strengthening

# Flotsam or Mainstay?

**T**he state of the cash flow collateralised loan obligation (CLO)<sup>1</sup> market has been a question for several years but appears especially pertinent now. On the one hand, investors, wary of the price risk that all bonds present, seek a fixed income product offering attractive yield coupled with safety and protection from rising rates – a package that, historically, CLOs purported to provide. But in spite of increasing confidence in the durability of the US recovery, a “credit bust” persists for key segments on which the economy depends. These

borrowers are financed primarily by banks, and the co-investors – particularly CLOs – on which banks rely for both lending capacity and risk management. So, a failure of CLOs to return may present a void on both counts, unless borrower demand and investor demand stall, or a product substitute emerges. What lies ahead?

It has been argued that bank-dependent borrowers aren't seeking loans, and that US companies and private equity firms alike hold record levels of cash. Also, the syndicated loan market, where banks sell a majority

<sup>1</sup> All references to CLOs are US cash flow CLO investment products, not market value structures or so-called balance sheet CLOs used by banks



Peter Gleysteen, founder and CEO, CIFIC

of the senior-secured corporate loans (SSCLs) they originate to institutional investors, like CLOs (which accounted for 61 per cent of such sales in 2006 versus 38 per cent in 2010), remains anaemic. With too many investors seeking too few loans, the argument goes, there is no need for CLOs. But this is because a bull market in high-yield bonds has been refinancing SSCLs, so the stock of SSCLs is shrinking. Companies are simply taking advantage of record low interest rates as they stabilise capital structures. Real credit demand, versus debt rollovers, typically lags the start of an upswing in the US business cycle which, as it grows, brings corporate investment and M&A transactions, including LBOs. These require flexibility in terms that only SSCLs provide, unlike the “one size fits all” structures of bond financings. Also, bonds typically carry significant prepayment penalties that require a long-term capital structure decision which is not appropriate for many companies. And then there is the prospect of rising rates, which in the past caused SSCLs to disintermediate high yield, namely the reverse of recent financing flows. If the status quo persists, the same companies will continue as is, meaning no corporate reinvestment and M&A, which is highly improbable. Since most market

#### Peter Gleysteen – Résumé

Peter Gleysteen is the founder and CEO of CIFIC, a premier credit asset management firm. CIFIC recently announced a merger with Deerfield Capital Corp. (NASDAQ: DFR). Mr. Gleysteen will be the CEO of the combined firm, which will be based in New York. Before founding CIFIC, Mr Gleysteen spent 25 years at J.P. Morgan (JPM). He was the Chief Credit Officer during the JPMorgan Chase merger, prior to this position he was responsible for both JPM’s Global Syndicated Finance business and its corporate loan portfolio. Mr Gleysteen was a member of JPM’s Management and Credit Committees and co-chair of the Investment Banking Division Balance Sheet Committee.

forecasters see the future linearly, and underweight Keynesian “animal spirits”, a powerful and underestimated force, a growing pipeline of SSCL issuance and aggregate supply of them is more likely. Will the CLO market be there for the uptick in credit demand, and if so, should CLOs be a preferred choice for fixed-income investors?

We need to start with what happened to CLOs. It was a large and mature market that shut down, and while there are now glimmers of new issuance, forecasts for 2011 are a small fraction of prior levels. Most of the investors in CLOs formed part of the so-called “shadow banking” system, which has been estimated to total, capacity-wise, as much as banks themselves (recognising that much of the former were “off the books” extensions of the latter). But like current CLO issuance, that is now a shadow of its erstwhile self. Third, in mark-to-market valuation terms, many CLO investors suffered intense volatility, although prices rebounded sharply after the credit crisis and onset

of recovery. But those who were forced to sell took real losses (banks called in market value-based financings, which excluded CLOs as these are cash flow, not price based). Then there is the guilt by association with CDOs, with which they share superficial features. There is also the notoriety concerning the SSCLs that underpin CLOs (many politicians and others frequently criticise leveraged borrowers in spite of their status as significant employers). This is compounded by ongoing confusion among many, as to the differences (other than floating versus fixed coupons) between SSCLs and high-yield bonds. This is exacerbated by how the industry typically measured CLO performance, namely default rates of SSCLs inside CLOs, which are the same for bonds (assuming a borrower has both a loan and a bond, which is typical). Not only do defaults not prefigure credit losses in CLOs, but they are point in time statistics that indicate nothing that may have happened between reporting periods, including

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SSCLs that defaulted and were sold (this is an area bank research could helpfully explore).

Addressing these questions, but not necessarily in order, will summarise facts and conclusions including that CLOs outperformed other investment products through the cycle, that while their investor base has been decimated (totally unrelated to CLOs themselves), this will be to the benefit of future investors, and that both past and expected CLO investment attributes are very

attractive. Indeed, CLOs may become a key product for sovereign wealth funds (SWF), endowments and especially pension funds and others globally. These institutions are grappling with the shift from savers building “nest eggs” to retirees drawing them down. This requires a transition from growth-oriented investment products associated with equities and alternative investments, to ones targeting distributing income while safeguarding principal and protecting against inflation. CLOs are an

attractive and proven product for these needs.

So what is the CLO track record? It began with the onset of the financial crisis when investors retreated, and then exited the CLO new issue market. This was followed by the price collapse of all asset classes precipitated by forced selling, including SSCLs and CLO securities. Indeed, this seismic shift in supply and demand illustrated the linkage between CLO and SSCL issuance as both stopped simultaneously. The discounted sales of the overhang of unsyndicated SSCLs by banks precipitated unprecedented price declines and volatility, followed by an avalanche of forced selling that drove average SSCL prices below 65. As many have pointed out, this was both below average high-yield bond prices and below prior (and subsequent) recovery levels for individual defaulted loans (which in aggregate typically account for 2-3 per cent through a cycle for a diversified portfolio). These price levels implied that every SSCL in existence would default and then sustain losses greater than 35 per cent, which would mean that all high-yield and private equity funds were worthless. That this was not “transmitted” to the bonds or equities shows both how broken all markets were, and the dearth of capital to arbitrage this inversion of values. This paradox of SSCL prices is in part explained by the fact that SSCLs were assets for which forced sellers could find buyers, because as the name implies, SSCLs are senior to everything else, and are secured, with a claim on value, unlike junior capital. While the stratospheric default rates implied by these loan prices never occurred, SSCL defaults did spike to record levels (see Exhibit 1) and exceptionally low recoveries were widely anticipated. This was accompanied by rapid and across the board ratings downgrades by S&P, Moody’s and other credit rating agencies of both CLO securities and SSCLs. While the ratings (and prices) of CDOs and the assets they securitised remain comatose and will likely never recover

Exhibit 1: 12-Month Trailing Loan \$ Default Rate



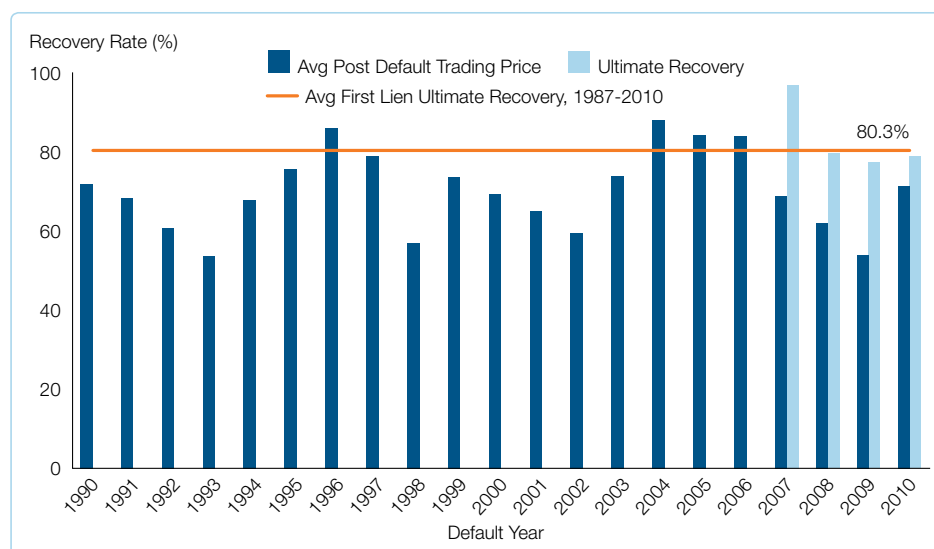
Source: Standard & Poor's

with few exceptions, those of CLOs and SSCLs generally have and continue to be steadily upgraded with many prices near par.

Why? CLOs and the loans in them performed as advertised. In fact, they outperformed given the unprecedented severity of the recession and of the SSCL price declines (which affected CLO cash distribution mechanics). CLO structures and the indentures governing them worked very well, redirecting cash from underlying SSCLs as appropriate to ensure high levels of protection that is integral to the CLO product design. The structures operated as intended to protect all classes of investors, including the so-called equity. CLO equity is a fixed-income “strip” junior to other CLO note holders, but in value terms is protected by the “value cushion” represented by the junior capital, including “real” equity, that sits below each individual SSCL in a CLO. This is a conservative investment product that worked well in a scenario worse than anyone envisaged. Indeed, recent Citi research estimates, in a base case scenario, a median equity internal rate of return for CLO equity of around 12 per cent which, as they point out, is the same level that was initially marketed for typical new issue CLOs.

In addition to having highly prudential structures to protect investors, which worked as intended under unimagined levels of stress, CLOs have excellent underlying assets as investments. Unlike CDOs which invest in generic, highly correlated assets (typically real estate or consumer based) and depend on top-down models for valuation and portfolio management, CLOs invest in SSCLs. With hindsight, the strong performance should not be surprising. While second order securitisations (such as CDOs of ABS securities) characterise CDO underlyings, SSCLs are senior secured loan contracts to individual corporate borrowers which have real assets, employees and cash flow. The contrast with “NINJA” (no income, no job, no assets) loans could not be more striking. In spite of the severity of

Exhibit 2: Senior Secured Corporate Loan Recovery Rates



Source: Moody's

the recession, and the calamities that afflicted many companies and continue for many former employees, the actual default and recovery rates for SSCLs defied expectations (especially when the economy and the markets were in freefall). What actually happened were that cumulative default rates did not set new highs, and recovery levels new lows (see Exhibit 2) across the trough of the cycle. Indeed, in spite of the “Great Recession”, neither materially pierced the preceding long-term averages. In contrast, as emphasised in recent Wells Fargo research, no CLO had an event of

default while more than 400 CDOs did.

If the structures and underlying assets are so resilient, why not simply invest in blind pools instead of CLOs which have an asset manager, or could there be “autopilot” CLOs in the future? Investment performance, especially for fixed-income products, starts with loss avoidance. In the case of CLOs, this means minimising realisations lower than the investment price of the underlying SSCLs, be it through a sale or a lower recovery for a default (unless in either case these are offset by corresponding realised gains). CLOs and

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SSCLs are, respectively, conservative investment products and asset classes. The principal role of a manager is to maximise the defensive characteristics of SSCLs within the CLO’s structure as these interact with changing economic and market developments. Managing risk by selling is the primary tool for portfolios of almost all asset classes. With CLOs this process begins with the initial selection of assets, then continues with the rebalance of the portfolio by selling some assets to reinvest in more attractive ones on a relative value basis to improve portfolio quality. The goal

is to have as few problems as possible and maximize the amount of ultimate realisation of proceeds. When the market as a whole has recognized a problem, selling may or may not be a good idea. With SSCLs it is usually better (albeit not always) to hold, not sell. While perhaps counterintuitive, this is because the seniority and security that distinguish SSCLs from everything else has value only under economic duress (other asset classes do not have collateral as a “second way out”). Selling SSCLs can be compared to throwing away a life jacket when a ship is sinking

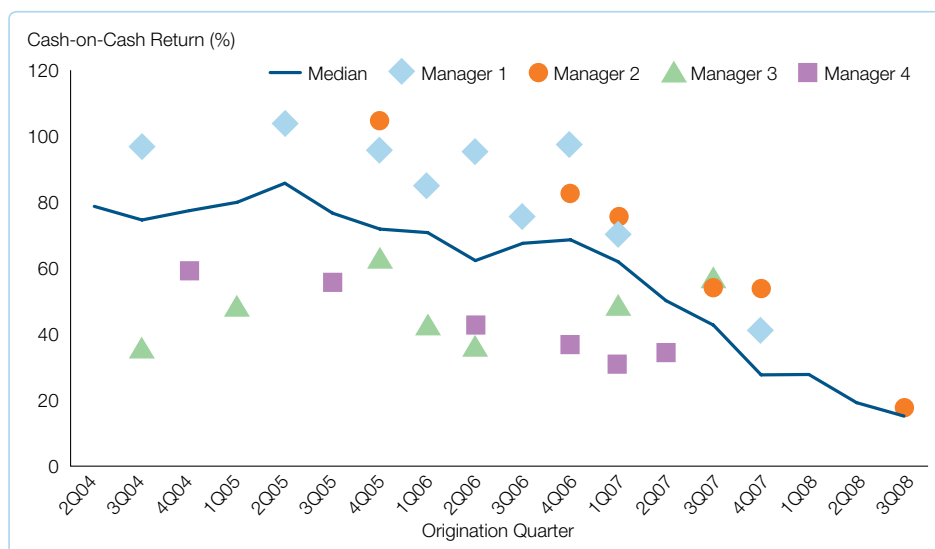
(this phenomenon is of course the driver of vulture investing). The manager has to make the judgment, repeatedly, as SSCL problems, like those of its borrowers, take time to “work out” (hence that banking term for restructuring). This value added by managers, which must be based on their independent analyses rather than that of credit rating agencies or market prices (even though these are useful secondary data points), is one of the many reasons CLOs performed so well through the 2008-2010 debacle, and what distinguishes the best managers from others.

Citi research points out that the factors driving CLO performance were vintage, structure and the manager, but that the best managers outperformed irrespective of vintage or structure (see Exhibit 3) and achieved average cash on cash returns to the equity greater than 5 per cent per quarter.

In addition, managers can add more alpha because the primary and secondary markets for SSCLs are opaque, inefficient (befitting perhaps an asset class originated by and in markets made by banks) and replete with investors with different objectives, including of course banks, CLOs, retail loan funds, hedge funds, insurance companies and vulture investors. So the opportunities to arbitrage price and value differentials are substantial.

The structures are robust, performance impressive and managers important, but will SSCL yields be high enough

Exhibit 3: Returns of US CLO Managers



Source: Citi Investment Research and Analysis

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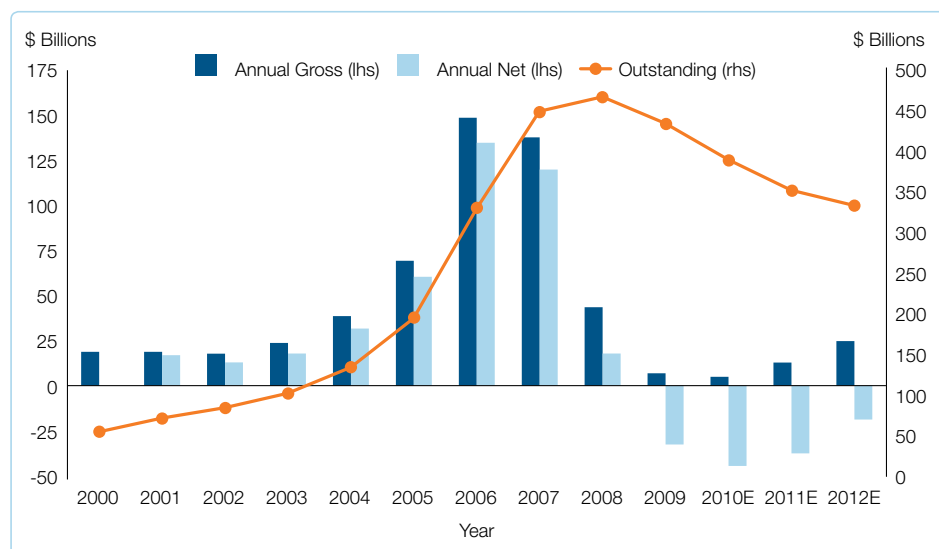
to make CLOs work in the future? If the performance of CLOs is the first big surprise, the second is that SSCL yields have effectively been transformed. How else to describe levels that are two to three times historic averages in market conditions that would normally compress them (cash-driven technical markets whose SSCL base is shrinking)? But the return of so-called new money SSCL issuance will push yields up. The deleveraging of the financial system is a structural rather than cyclical change and has caused a seismic shift in supply and demand balance for SSCLs, which is hugely positive for CLOs. In addition, unlevered investors such as insurance companies require at least mid-single digit returns which can act as a floor to SSCL yields. This will be abetted by cyclically-driven credit demand discussed before. It should be emphasised that prior yield levels amply funded net credit costs of CLOs through the last cycle, so the step shift increase in yields is additional “excess spread” to further benefit investors, and this will help attract new ones. Further support to loan yields will likely come from any fall-off in high-yield issuance due to any rising expectations on rates, as well as the so-called loan maturity wall – upcoming SSCL and high-yield maturities coincident with that of CLO maturities, which are forecast to have negative net new issuance for many years (see Exhibit 4).

There are alternatives to CLOs such as retail funds, hedge funds and cross-

over bond investors but their involvement is sporadic and usually relative value driven by temporary asset class dislocations, not fundamental allocations to the SSCL asset class. What is needed is entry by so-called “real money” investors with long-term obligations to fund. These are insurance companies, pension funds and distributors of investment products designed for similar needs, plus SWFs, endowments and others globally. These are not pools of “in and out money” similar to that pouring into SSCLs now, but long-term funds that require a tried and

true product, one that is large scale, has demonstrated excellent performance, has liquidity, transparency and is professionally managed with many firms to choose from. In addition, CLOs and SSCLs both have low correlation to other investment types and asset classes, and are floating rate, thereby immune to rising interest rates. Importantly, both pay cash quarterly. Given global demographics, CLOs are a proven product that offers what retirees need: safety, inflation protection and a cash return typical of annuities. CLOs also include an array of product subsets

Exhibit 4: CLO Gross/Net Supply and Outstandings



Source: J.P. Morgan

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from which to choose (AAA to BB rated plus subordinated notes, aka CLO equity) to best match yield and safety objectives.

But what about net asset value (NAV) volatility? This measure of value is critical for a forced seller, or an investor requiring continuous liquidity, but most agree it is not adequate for held-to-maturity investments. The debate between fair value and historic accounting continues, and unfortunately, are posited in Manichean, “my way or the highway” terms. Also, the volatility experienced in 2008-09 may not likely be repeated soon as the debt contraction (SIVs, conduits, market value bases leverage, etc.) has been expunged from the financial system for some time. Importantly, the beneficiaries of long-term investments, such as pensioners, can only spend cash distributions, not NAV.

And what about regulation? CLOs contain assets that are originated and securitised by banks. An optimistic view would have lobbyists, politicians and regulators produce something appropriate and forward looking. Hopefully, responsible parties will distinguish between SSCLs to borrowers in CLOs from what are inside CDOs. Importantly, CLOs also add capacity to capital markets serving corporate borrowers and relieve banks of excess credit concentrations. Both the Fed and the Loan Syndications and Trading Association are alert to the potential for public policy errors, but this remains an open question.

CLO issuance levels now are minuscule. Current forecasts for 2011 CLO issuance are a small fraction of prior levels, only \$10bn-\$15bn. To date, most new CLOs have been refinancings of existing pools of SSCLs, with the original CLO owner supplying all or most of the “equity”. This appears to be changing, and “fully distributed” CLOs are beginning to emerge. Current questions about CLOs include whether liability costs will come down, or whether SSCL yields will hold up enough to make the so-called “arb” work, and so forth. But this reflects an episodic rather than a real market, as neither CLO nor SSCL issuance volumes are of any consequence as yet. CLO issuance is linked to that of SSCLs. When that expands, it will need to attract new investors as before, with attractive terms and conditions, especially yield. Investors, except in market crises, react in a predictable way, and go to where the value is. CLOs are likely to be the product of choice. So the past will likely presage the future. In addition, the new structures are essentially the old ones, which is not surprising and is even desirable, given their robust performance.

CLOs are a proven investment product with an impressive track record. These make them attractive for retiree type investors and give them arguably a superior product format for SSCL investments. New types of investors with substantial capacity are required if SSCL issuance can return to levels

seen in the middle of the last decade. The implications are significant, for as before, it is CLOs that are most likely to deliver institutional investors to the SSCL markets. And as in the prior cycle, it will take time and effort, hindered also by elimination of most of the so-called bank “sell-side” which warehoused, manufactured and distributed CLOs.

Markets and the issuance of products such as CLOs are driven by the interplay of supply and demand. The rebound of SSCL issuance will likely drive that of CLOs, and the “transformation” of SSCL yields will attract the required new sources of capital. Capital is amply available and investors are anxious to redeploy away from cash and Treasuries. While past cycles have typically transitioned from an investor-driven phase to a product innovation one, this cycle may prove an exception.

It cannot be emphasised enough that CLOs are conservative investments that magnify the defensive characteristics of the SSCLs that underlie them. The CLO product, and its excellent and battle tested track record, is especially well suited for the investment needs of global fixed-income investors and the retirees they will increasingly serve. CLOs are likely to anchor long-term investment strategies, both as standalone products and as “sleeves” alongside ones that will be well served to be complemented by their stability, floating versus fixed rate, and current cash profile. ■