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'Apprehension' ahead as CLOs hope to dodge 2018 repeat

CLO MANAGERS are hoping to avoid a repeat of the ugly end to 2018, with some credit buyers opting to sit on their hands and wait out what is expected to be a period of thin liquidity and shaky sentiment. Despite a spate of nervousness and some late-cycle behaviour, however, underlying metrics in the market still look mostly sound, according to Steve Vaccaro, chief executive of CIFC, one of the largest CLO issuers.

"Similar to what we saw in 2018, there's a certain amount of apprehension regarding risk-taking heading into the last six weeks of the year," said Vaccaro. "Accordingly, we expect CLO issuance will significantly fall from levels we saw earlier this year as we approach year-end."

Meanwhile, lots of commentators are eyeing aspects of the market nervously, from the announcement that KKR is considering the largest ever LBO (the take-private of Walgreen-Boots) to the continued concerns from regulators about the leveraged finance market.

The IMF, for example, flagged leveraged lending as a crucial concern in its latest Financial Stability Report, while the Financial Stability Board has also launched an investigation into the sector. Some weakness has also been seen down the capital structure in CLOs on both sides of the Atlantic in recent weeks.

According to JP Morgan, "demand for euro [triple-A rated paper] has been able to offset weakness in junior liability spreads, acting as an anchor on blended funding costs across the CLO liability stack. The same cannot be said in the dollar market, where [triple-As] have been unable to track euro spreads tighter."

But regulators' fundamental worries are misguided, argued Vaccaro, for several reasons. The most fundamental of these is the excess spread still available in leveraged loans. The dominance of covenant-lite structures ought to increase the loss-given-default of leveraged loans, but even so there's a lot of spread cushion left — and, usually, value left in a company.

Losing all the collateral pledged to a secured loan is the logical end point of 'covenant-lite' structures with extensive Ebitda add-backs and routes to siphon out money to equity holders, but loans remain senior creditors to whatever enterprise value is left.

"I'd like to see discipline in the market, I'd like to see appropriate leverage, I'd like to see improvements in the quality of Ebitda," said Vaccaro. "It's not a question of looking for six times leverage, it's about six times what? A six times deal can really turn out to be an eight times deal."

Moody's estimated, in a research piece published at the end of October, that the loss-given-default for the current cohort of US leveraged loans would be 61%, against a historic average of 77%. At existing default rates of about 3%, that suggests an annual credit cost of 183bp, against an average single-B loan spread of 440bp. In a CLO structure, this is protected even further by the tranching and diversity of the portfolio.

"In a downturn scenario, we expect defaults and losses to be higher, but not to the degree that people may think, and there's plenty of excess spread in CLO structures," said Vaccaro. "You are being well compensated for the likely losses and recoveries. And, let's remember, CLOs are a structured product that has proven that it can withstand a crisis."

Adding products

CIFC, which is owned by merchant bank Centricus, printed its first European CLO this year. It also launched a structured credit UCITS fund at the start of the year — and plans to add other debt products in areas close to leveraged loans and structured credit.

It is not, however, planning to join the rush into direct lending markets.

"There's a logic to the strategies we choose to add to our business. We are looking to grow around our core competencies in credit by adding different risk profiles," said Vaccaro. "Take, for example, middle market lending. While we have given thought to getting into the asset class, there are other areas that make more strategic sense for us to grow first. Middle market lending is very capital intensive, because you need to build your own origination capabilities. You are not only investing in loans, but also sourcing and structuring product, so it requires building out a team of professionals with those skill sets."

The firm had been building up its European operations, from a single person last year into an office of at least 10. In October 2018, it hired Apollo's Dan Robinson as CIO in Europe, and has also been adding analysts and back office staff.

It is far from the only operation to see the merit in establishing (or re-establishing) a European CLO business. Arbitrage in Euro-

pean CLO equity has been more attractive than in the US for much of 2018 and 2019, and leveraged credit markets are increasingly global, with lots of the larger issuers present in both currencies.

But the market structure is different and low supply at the beginning of the year has made it harder for all CLO managers, however well established, to ramp up deals.

"The process of launching our debut European CLO took a little longer than we had hoped, as the loan market saw relatively little activity, quality collateral was in short supply and we wanted to be patient and avoid doing something we'd regret," said Vaccaro. "We did not expand our business into Europe for a trade — it's a long-term build."

The deal was eventually priced in July, after the loan market had regained some of its composure, but keeping the market alive meant some managers sucking up issuance costs themselves just to get deals over the line.

"We believe a lot of the incremental new issuance during the first half of 2019 was driven by managers who were essentially constructing deals on uneconomic terms, subsidising the equity, and accepting single digit returns," said Vaccaro. "That's not a sustainable business model."

He said that, eventually, this could point the way to a more concentrated market for managers.

"Consolidation between managers will come, but not quite yet," said Vaccaro. "There are advantages to scale and specialisation. For example, when we do a deal, we have a dedicated capital markets team that can focus on structure and execution, so we aren't required to distract a portfolio manager from making investment decisions while we issue a CLO." GC