The Resurgence of the CLO Market

Meredith Coffey, LSTA – Moderator

John Clements – Citigroup
David Golub – Golub Capital
Bret Leas – Apollo
Rob Zable – GSO/Blackstone
What’s new in CLOs…and what does it mean for loans?

- CLO’s stunning performance to date…do investors care?
- What does CLO issuance look like in the near term? The medium term?
- How will changes in CLOs change the loan market?
- The $64 billion question: Could regulation squash the CLO revival?
- Outlook or “How I learned to stop worrying and love CLOs”
Section 1: CLO performance and investor base

- Brief performance recap…
  - Prices and ratings and losses…oh my!
  - What do CLO AAA spreads indicate?

- New investors?
  - What makes CLOs attractive?
  - How has the investor base changed?
  - What are these new investors looking for?
Performance: CLO prices and ratings recover

Source: Citi Research, Moody's
Performance: CLO note impairments have been all but non-existent

Cumulative impairment rate from Jan 1996 to May 2012

- Unimpaired: 98.57%
- Realized losses at mat: 0.78%
- Market value EOD: 0.02%
- Dist. Exch.: 0.17%
- Other: 0.46%

Source: Moody’s Investors Service
Performance: CLO losses lower than most other asset classes

Source: Moody’s Investors Service
CLO AAA spreads remain wider than other asset classes...warning sign or opportunity?

Source: Citi
Section II: How will CLO volumes change?

- In the near term...
  - CLO issuance has rebounded...
  - ...But making the economics work is challenging

- In the medium term...
  - How big will issuance become?
  - Will CLO issuance match CLO amortization?
  - Where does the CLO market stabilize?
  - What does this mean for CLOs’ role in the loan market?
CLO issuance is recovering in 2012

Source: Citi
CLO issuance climbs in 2012; CLO AAAs fluctuate

CLO issuance rebounding, AAA spreads moving roughly inversely to volume

Source: Thomson Reuters LPC
In the short term: The arb is challenging...

CLO AAA spreads widened as loan spreads narrowed…

…counter-balanced by tightening CLO mezz spreads

Source: Thomson Reuters LPC, LCD, Citi
In the short term: How do secondary loan prices & warehousing (or lack thereof) affect CLO performance?

Source: S&P/LSTA Leveraged Loan Index, Thomson Reuters LPC
Medium term: Vintage CLOs will disappear rapidly

Cumulative decline in CLO reinvestment capacity and CLOs outstanding

Source: Citi Research
CLO issuance has to top YTD 2012 levels just to offset CLOs going out of reinvestment

CLO issuance: Historical vs. amount needed to replace CLOs going static

*Assumes post-reinvestment capacity of 50% in year 1, 30% in year 2, 20% in year 3

Source: Citi, LSTA
Section III: How a changing CLO market could lead to a changing loan market

- Why CLOs are especially important to the loan asset class
- The interplay between vintage and new CLOs
- How changing CLO cost of funding will impact loan spreads
- Will LIBOR floors stick?
- Will CLO baskets ultimately constrain covenant lite loan issuance...or will baskets constrain CLO performance?
- Are Amends & Extends a one-cycle event?
CLOs remain the biggest single institutional investor, Bringing stability to loans … for now?

Investor market share in primary

Source: S&P/Capital IQ/LCD
Loan wish lists: Vintage CLOs vs. new CLOs

- **Vintage CLO wish list**
  - Needs shorter-maturity loans due to WAL test
  - Can tolerate lower spreads due to lower WACC
  - Limited covenant lite constraints
  - Limited Amend & Extend constraints
  - And more….

- **New CLO wish list**
  - Call protection
  - Can do long-maturity loans
  - Needs higher spreads due to higher WACC
  - Covenant lite constraints
  - Amend & Extend constraints
  - And more…
Loan spreads are much higher than mid-2000’s… Any chance they return to those levels?

Source: S&P/Capital IQ/LCD
CLO Weighted Average Cost of Capital (WACC) has climbed markedly...

2007’s CLO WACC: **44.5 bps**

Today’s CLO WACC: **195 bps**

Source: Citi, LSTA
Higher CLO WACC in 2012 won’t support 2007 level loan spreads
Cross over investors also likely to leave when loan spreads get too narrow

Source: S&P/Capital IQ/LCD, LSTA
Relative value investors only interested in loans at certain yield points…will leave if spreads drop too low.

Hedge funds/HY/RV accounts play small role in higher rated (lower yielding) loans.

Source: S&P/LCD
LIBOR floors have supported CLO equity performance ...will they stick?

Source: Thomson Reuters LPC, Citi
Covenant lite loans return… but will new CLO constraints limit the cov-lite market?

Source: S&P/LCD
Section IV: CLOs and Regulation

- Risk retention…
- And FATCA…
- And Volcker Rule…

**OH MY!**
Outstanding and reinvesting CLOs vs. looming regulation

- Euro risk retention
- Basel III begins
- CLOs (probably) must register/seek commodity pool exemption
- FDIC assessments already underway; criteria for new assets change April ‘13
- U.S. Risk Retention: CLOs comply in 2015
- Volcker goes into effect
- FATCA principal/sales withholding begins
- FATCA reporting & interest withholding begins
- FATCA grandfathering ends

Source: Citi Research, LSTA
Key takeaways

- CLO performance was remarkably strong in the Great Recession
- CLO investors realize this and are returning
- But not in the same numbers…which means CLO outstandings may well contract
- In addition, the CLO investor base has changed, has different return needs…
- Which leads to a higher WACC…
- Which means loan spreads cannot contract like mid-2000s
- And new CLO constraints may lead to a different looking loan market