
The Resurgence of the CLO Market

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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"

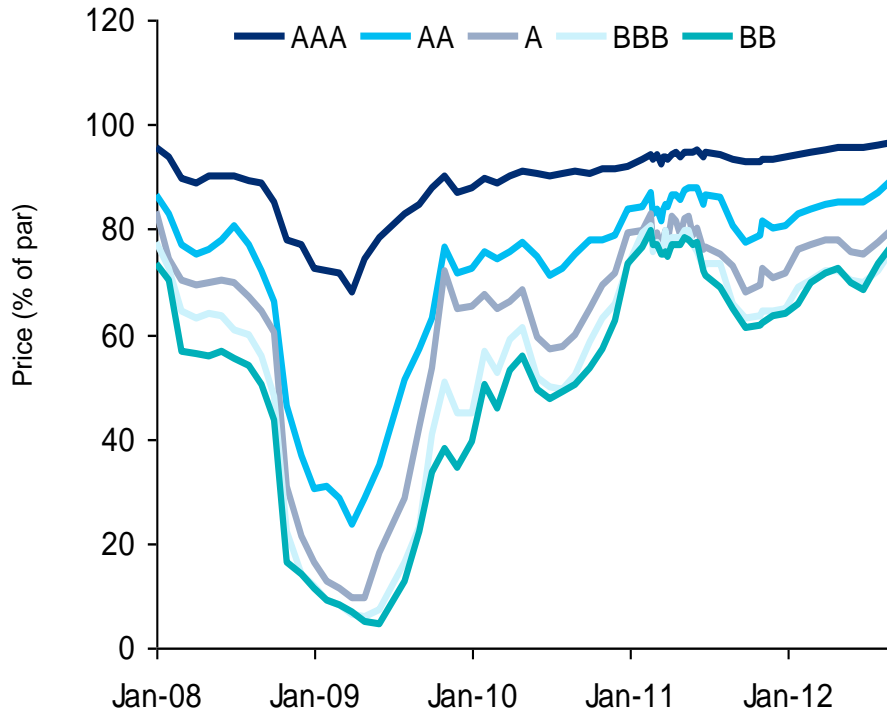
Section 1: CLO performance and investor base

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

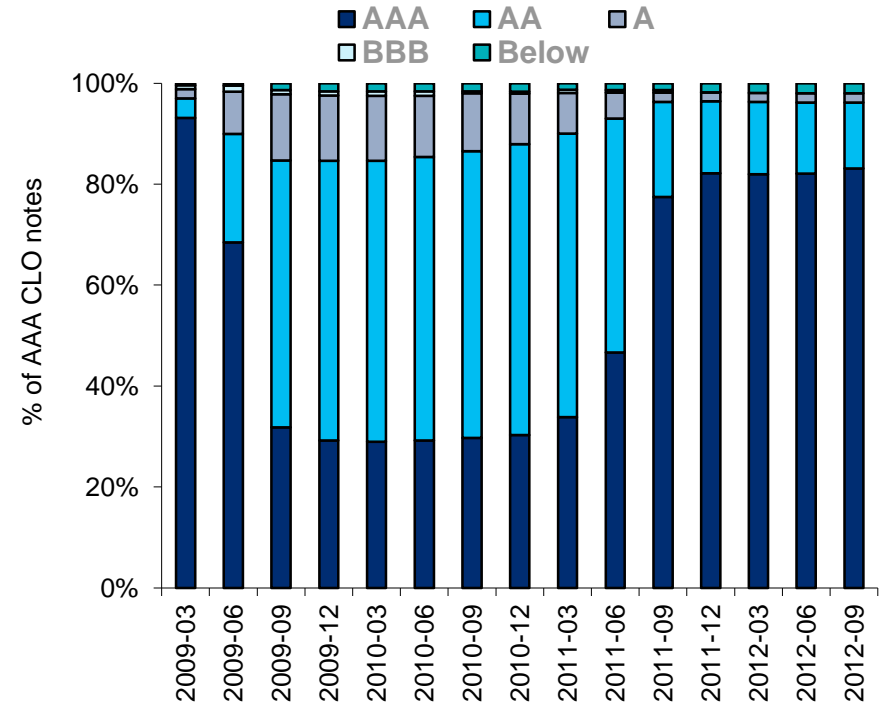
- New investors?
 - What makes CLOs attractive?
 - How has the investor base changed?
 - What are these new investors looking for?

Performance: CLO prices and ratings recover

CLO 1.0 secondary prices recover



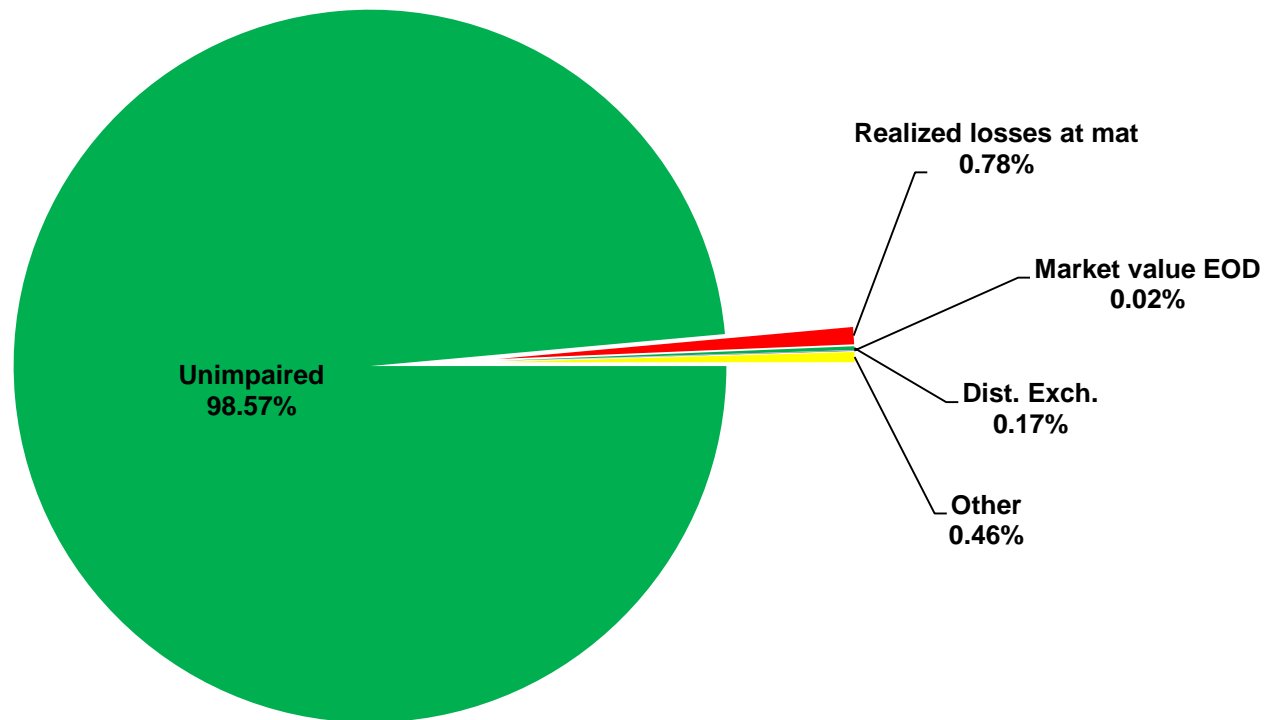
CLO AAA notes downgraded, but recover



Source: Citi Research, Moody's

Performance: CLO note impairments have been all but non-existent

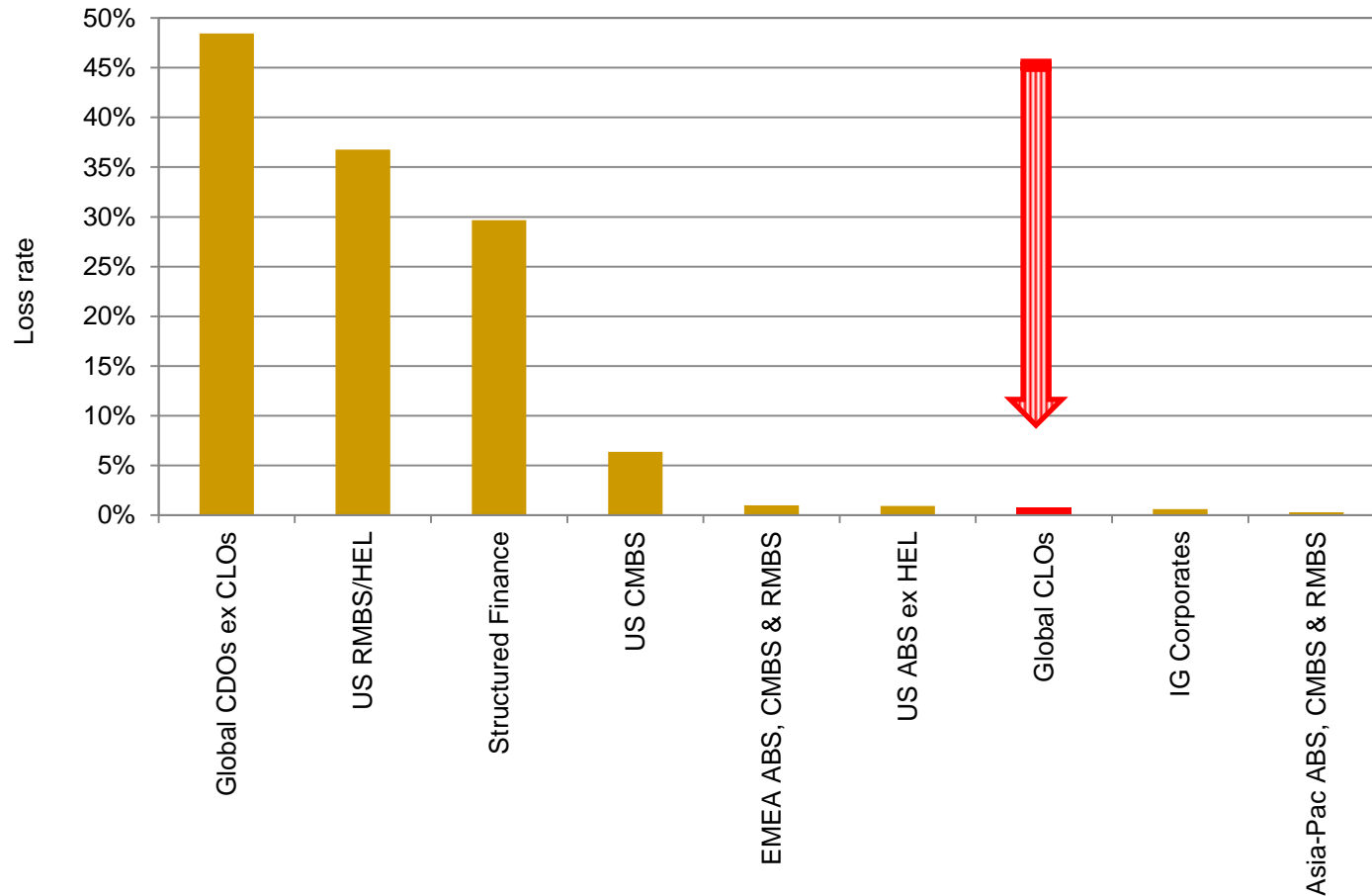
Cumulative impairment rate from Jan 1996 to May 2012



Source: Moody's Investors Service

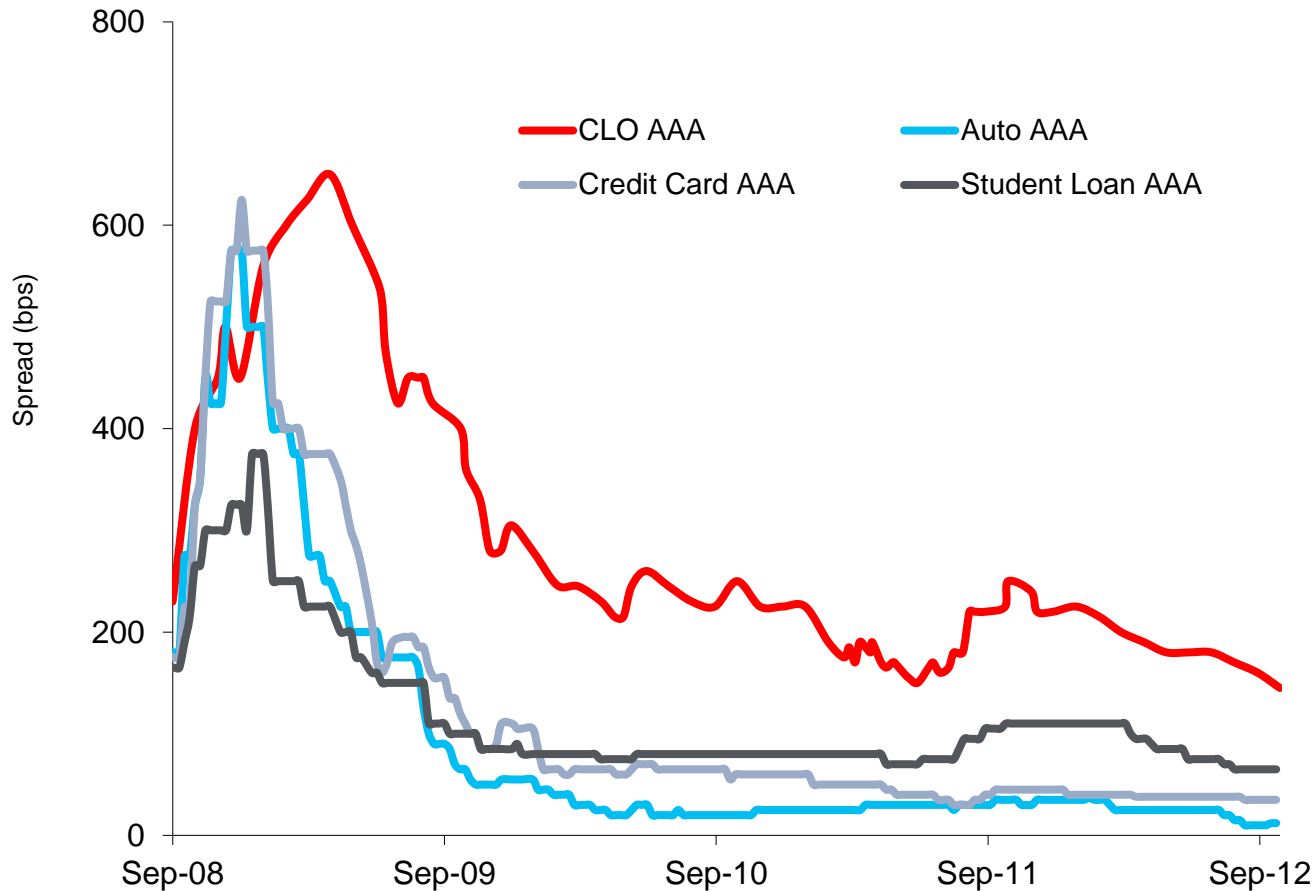
Performance: CLO losses lower than most other asset classes

Five-year cumulative IG loss rates



Source: Moody's Investors Service

CLO AAA spreads remain wider than other asset classes...warning sign or opportunity?



Source: Citi

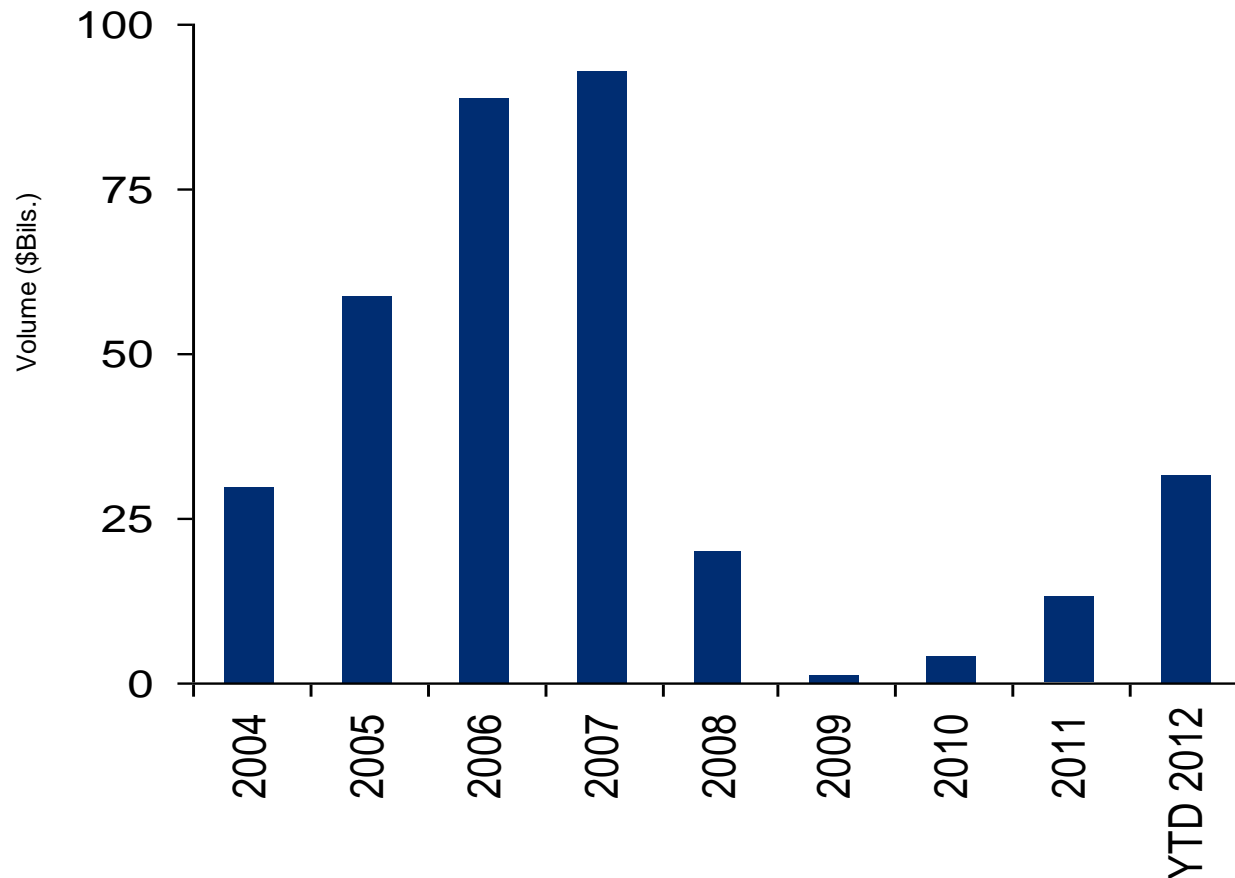
Section II: How will CLO volumes change?

- 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?

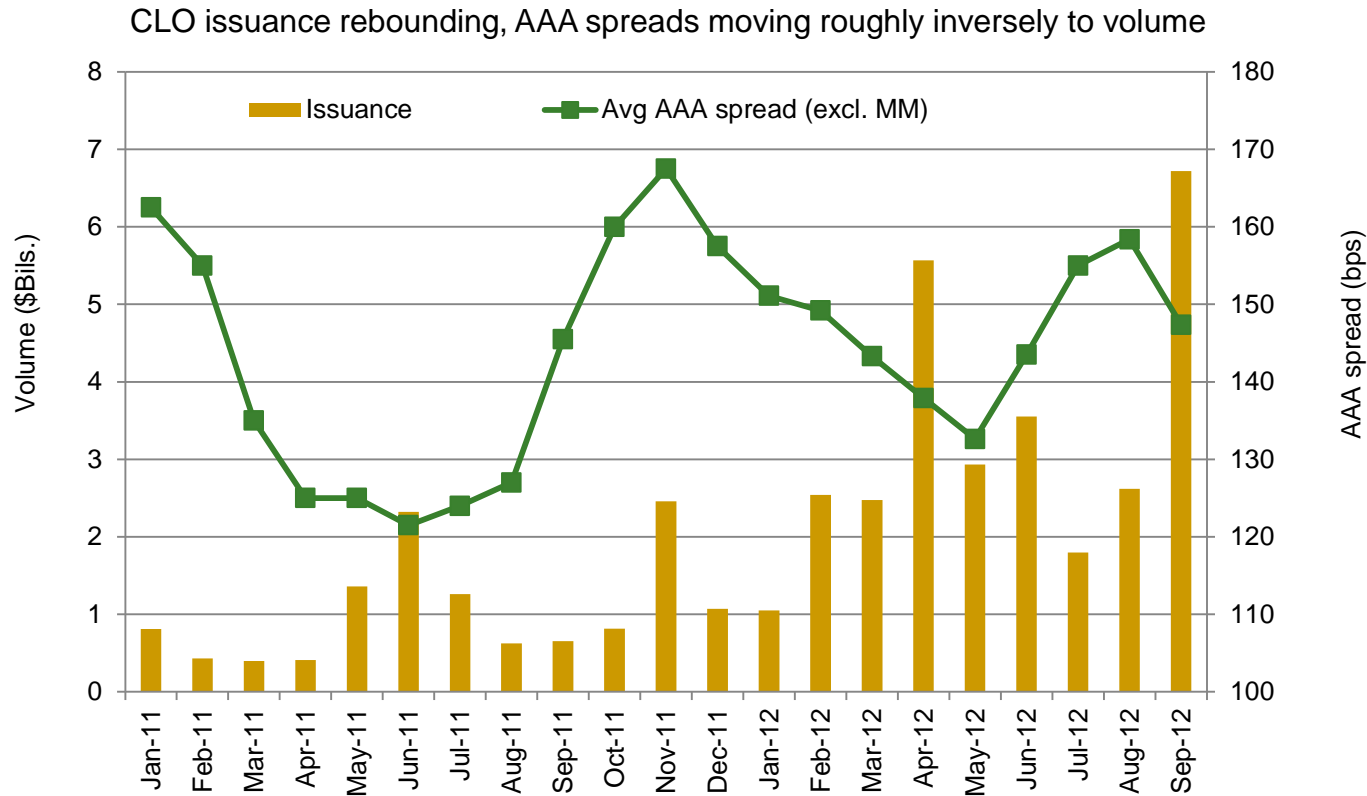
CLO issuance is recovering in 2012

CLO issuance rebounding in 2012....



Source: Citi

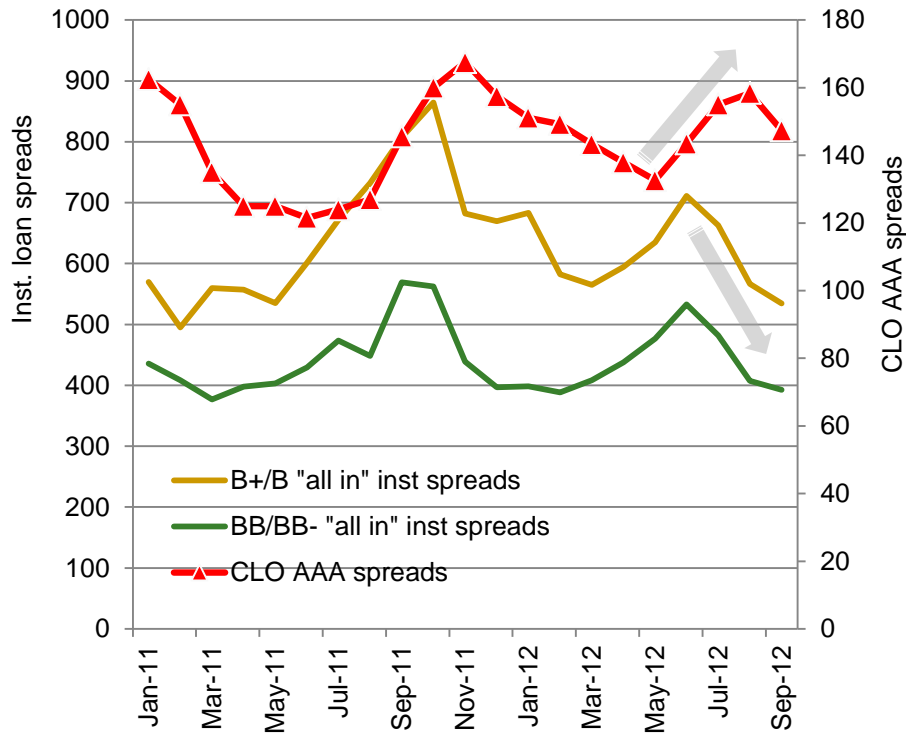
CLO issuance climbs in 2012; CLO AAAs fluctuate



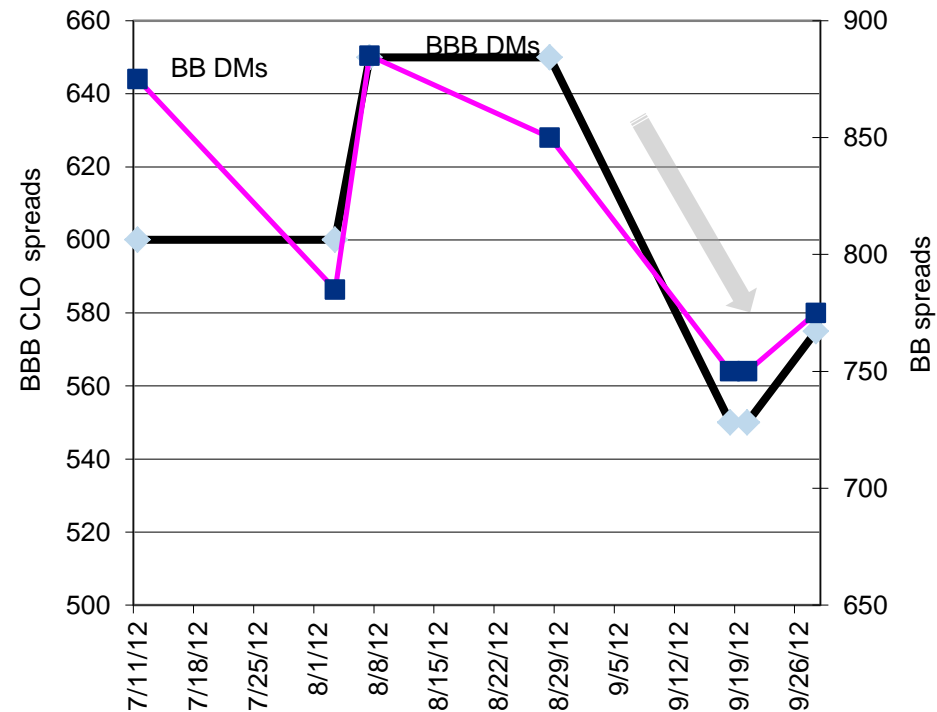
Source: Thomson Reuters LPC

In the short term: The arb is challenging...

CLO AAA spreads widened as loan spreads narrowed...



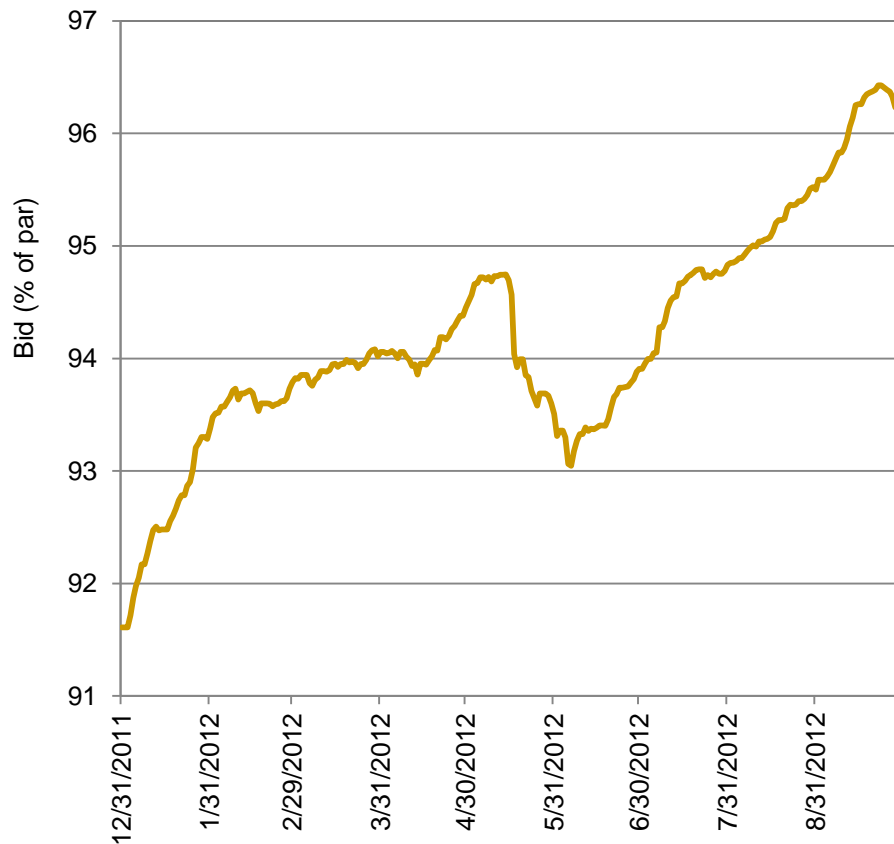
...counter-balanced by tightening CLO mezz spreads



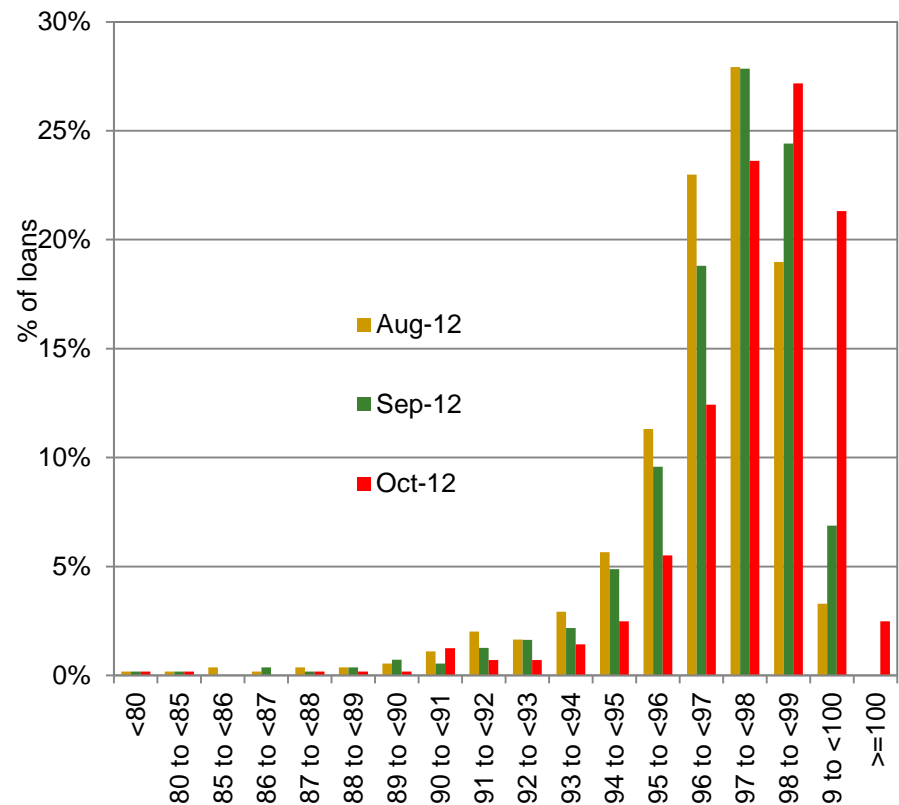
Source: Thomson Reuters LPC, LCD, Citi

In the short term: How do secondary loan prices & warehousing (or lack thereof) affect CLO performance?

Secondary loan bids rally...



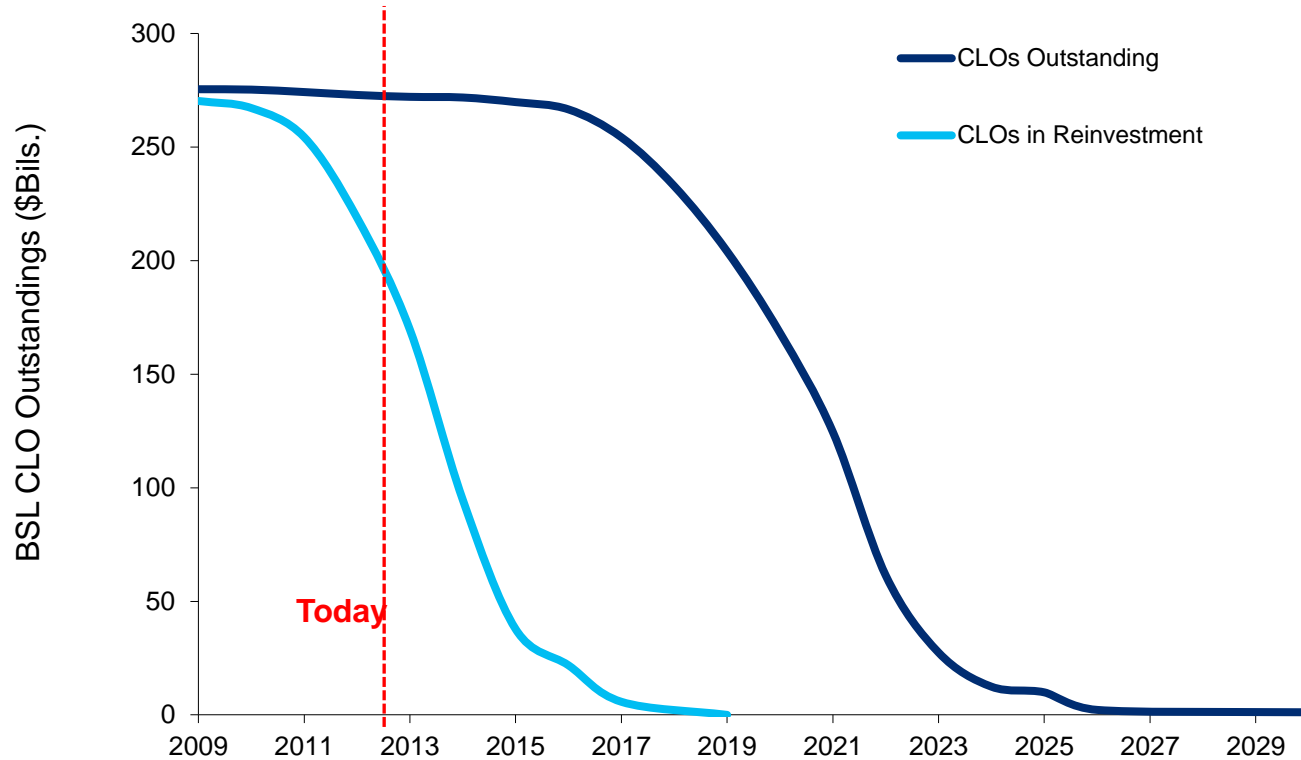
...Loan bids climb in CLOs



Source: S&P/LSTA Leveraged Loan Index, Thomson Reuters LPC

Medium term: Vintage CLOs will disappear rapidly

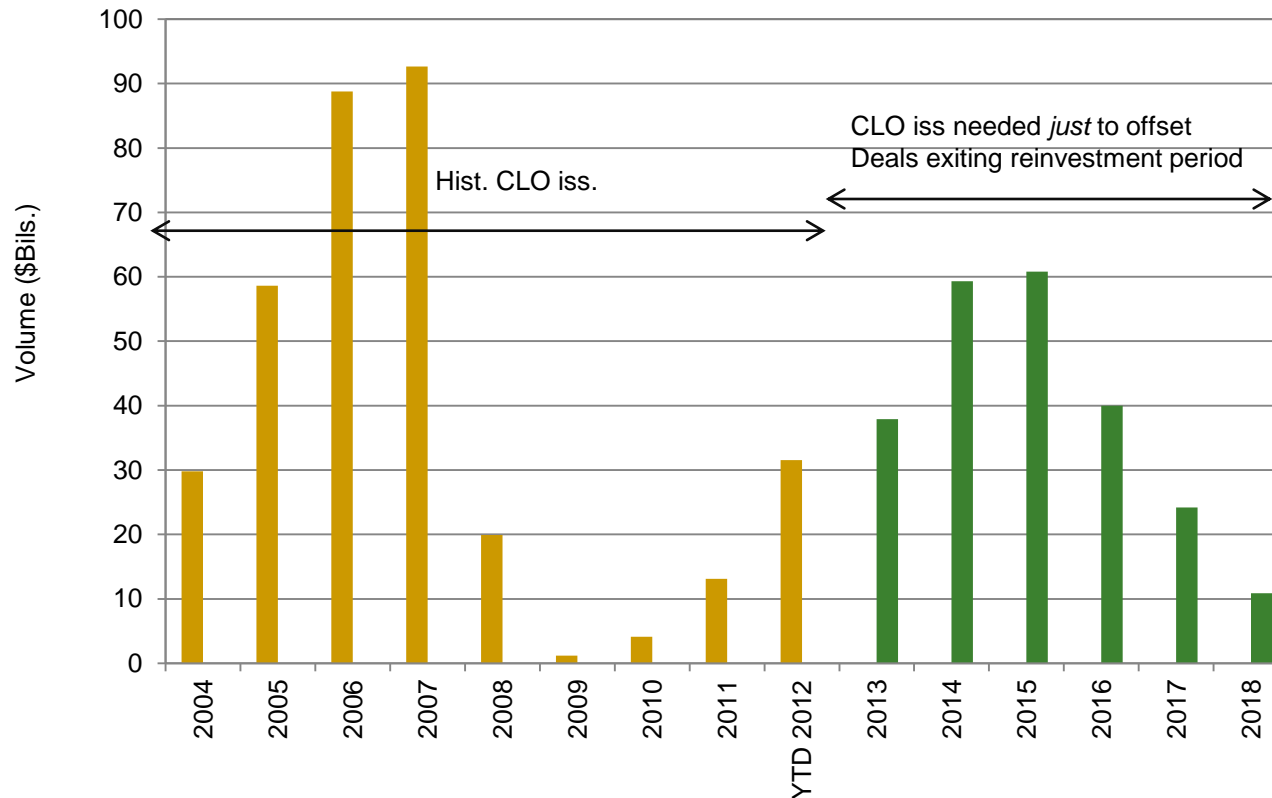
Cumulative decline in CLO reinvestment capacity and CLOs outstanding



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



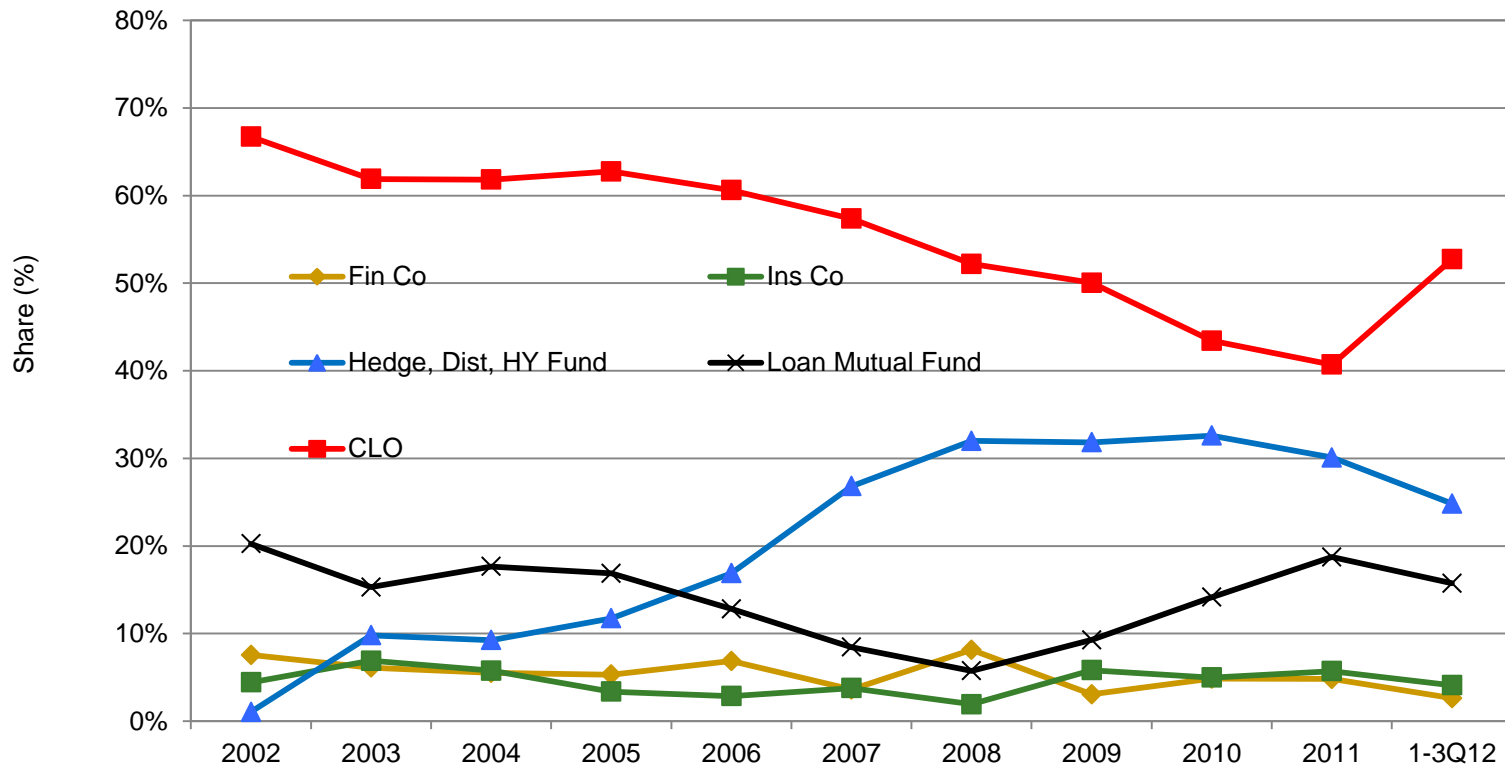
*Assumes post-reinvestment capacity of 50% in year 1, 30% in year 2, 20% in year 3

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

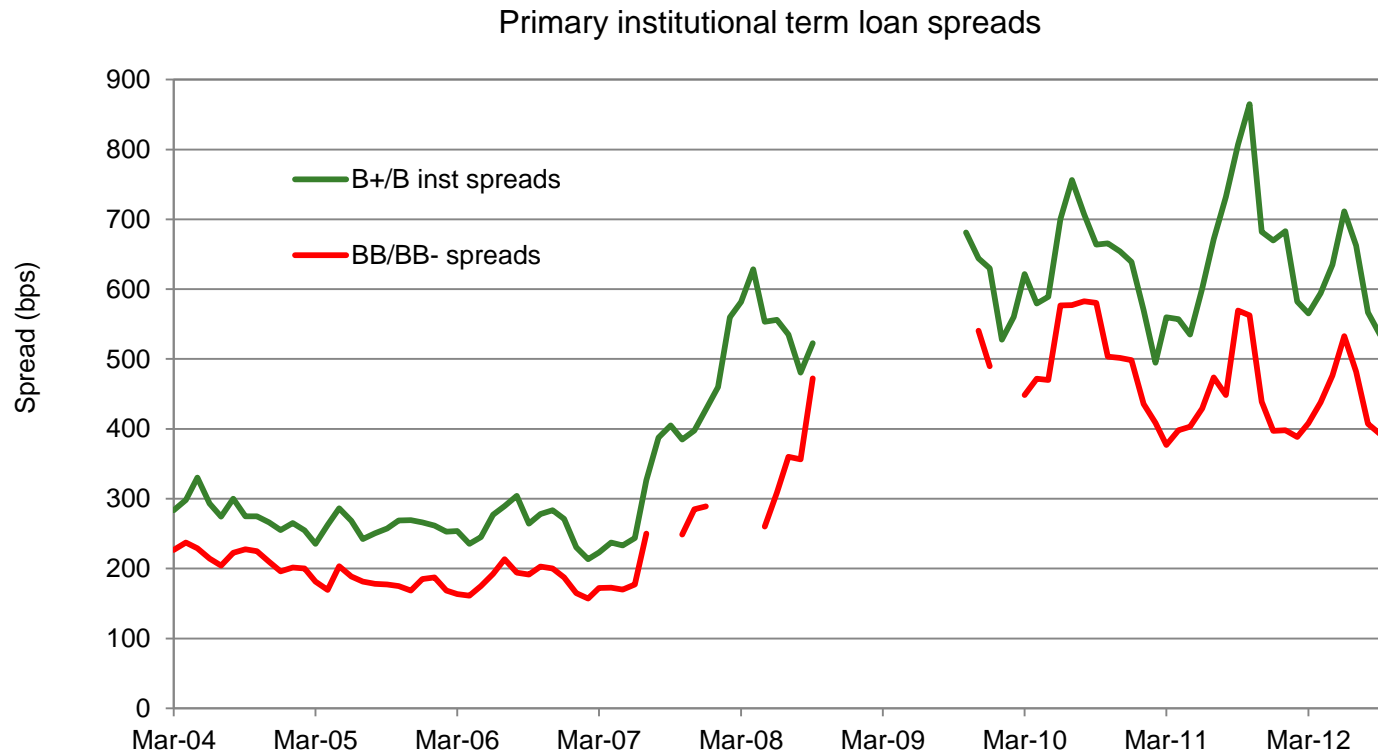
■ Vintage CLO wish list

- ❑ 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...

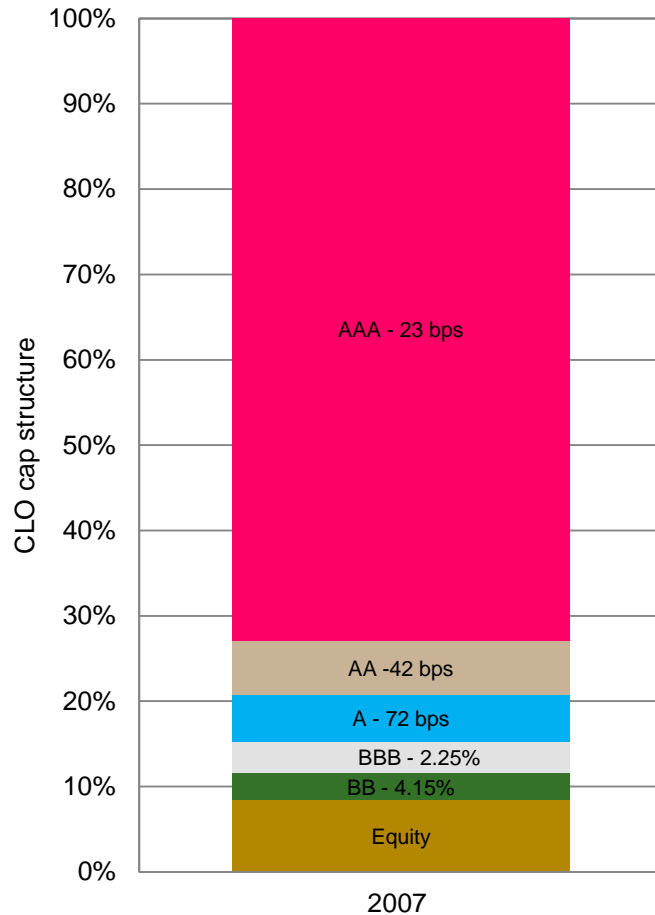
Loan spreads are much higher than mid-2000's... Any chance they return to those levels?



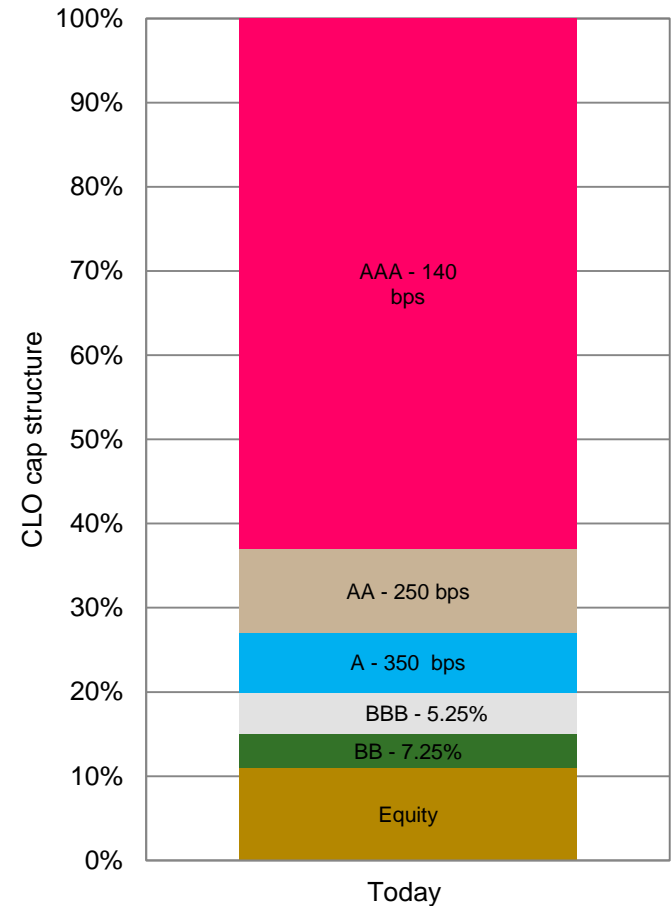
Source: S&P/Capital IQ/LCD

CLO Weighted Average Cost of Capital (WACC) has climbed markedly...

2007's CLO WACC: **44.5 bps**



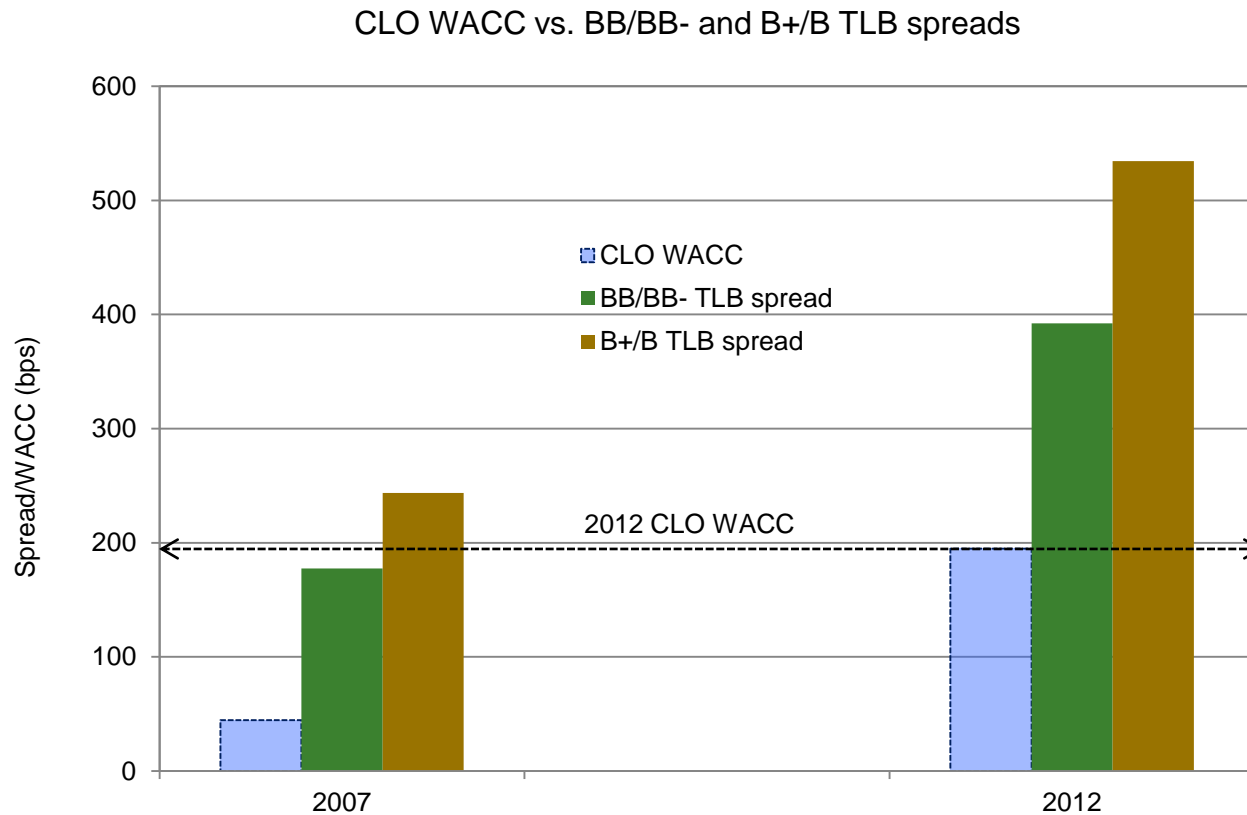
Today's CLO WACC: **195 bps**



Source: Citi, LSTA



Higher CLO WACC in 2012 won't support 2007 level loan spreads

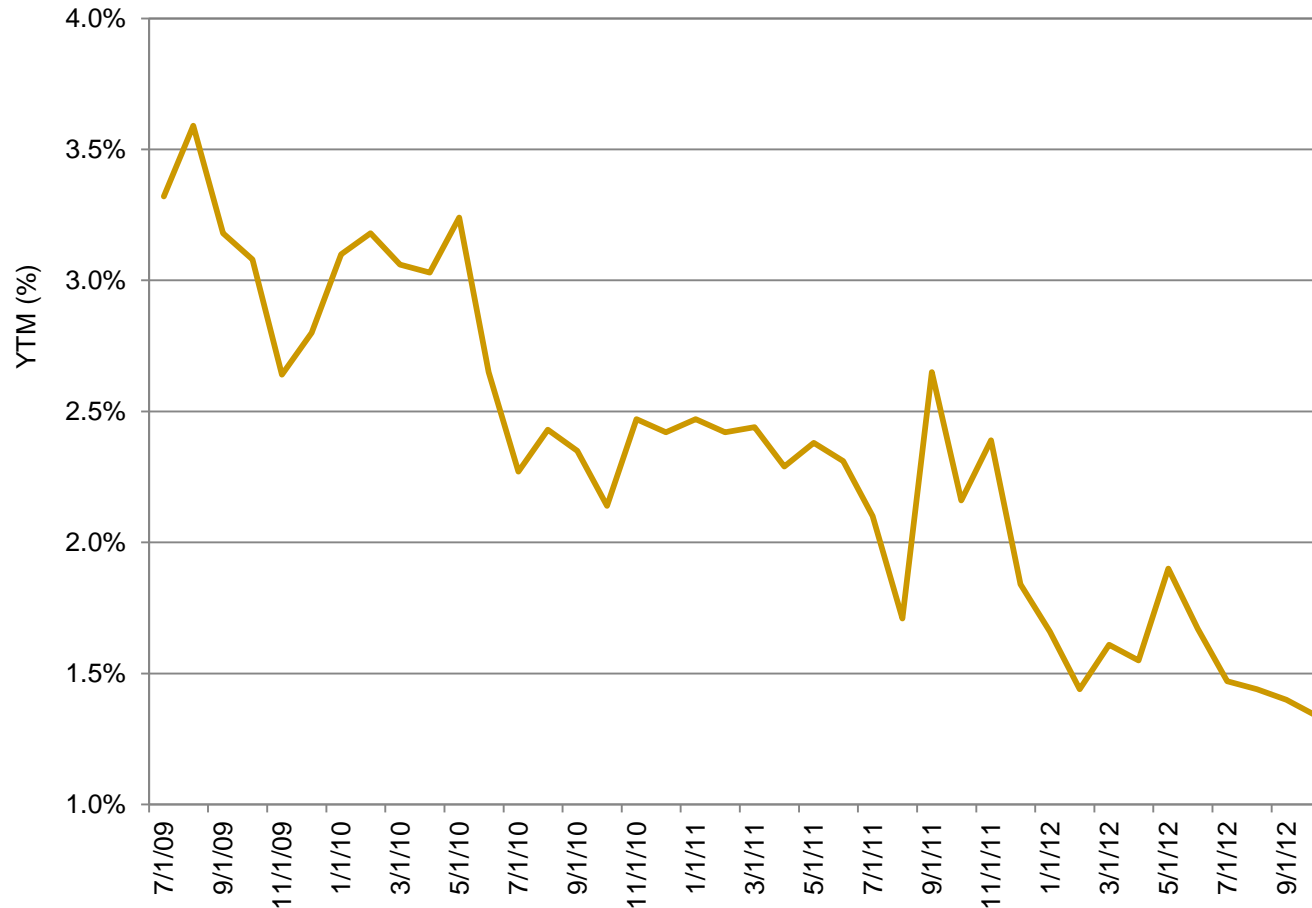


Source: Citi Research, S&P/LCD, LSTA



Cross over investors also likely to leave when loan spreads get too narrow

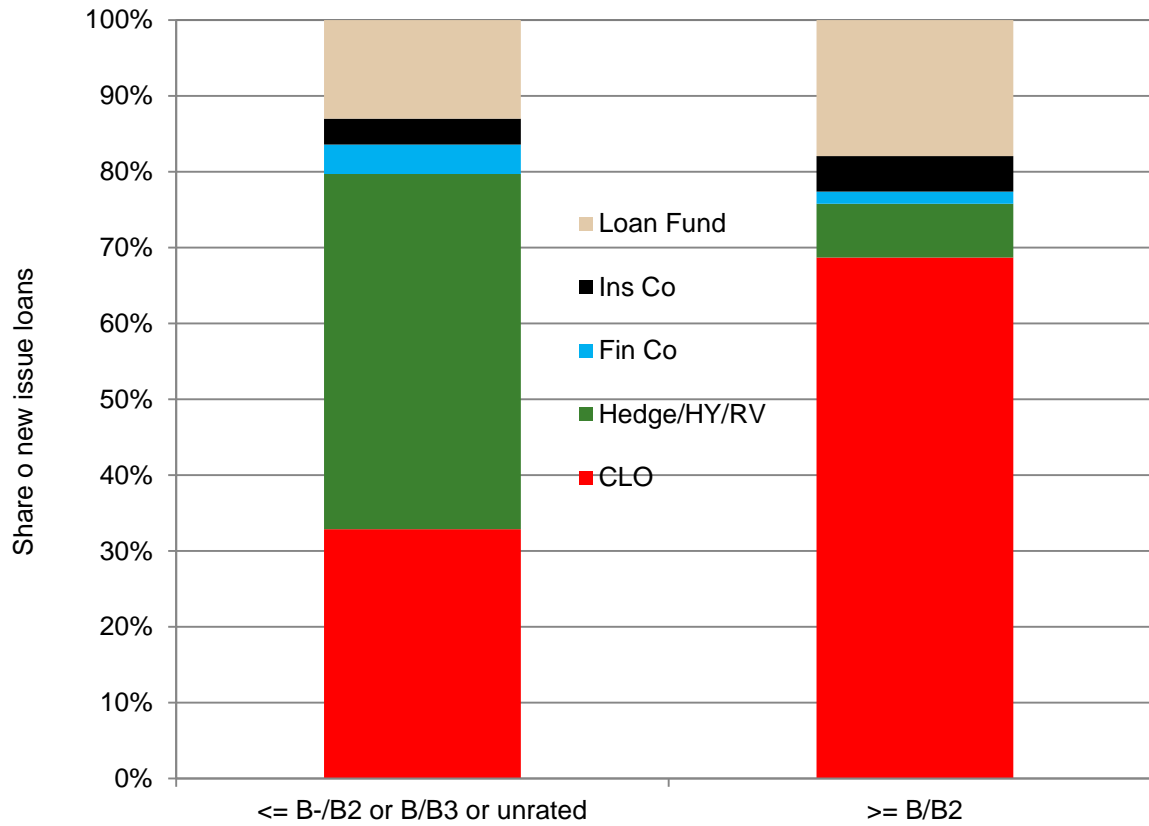
Loan-bond yield differential has fallen sharply



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

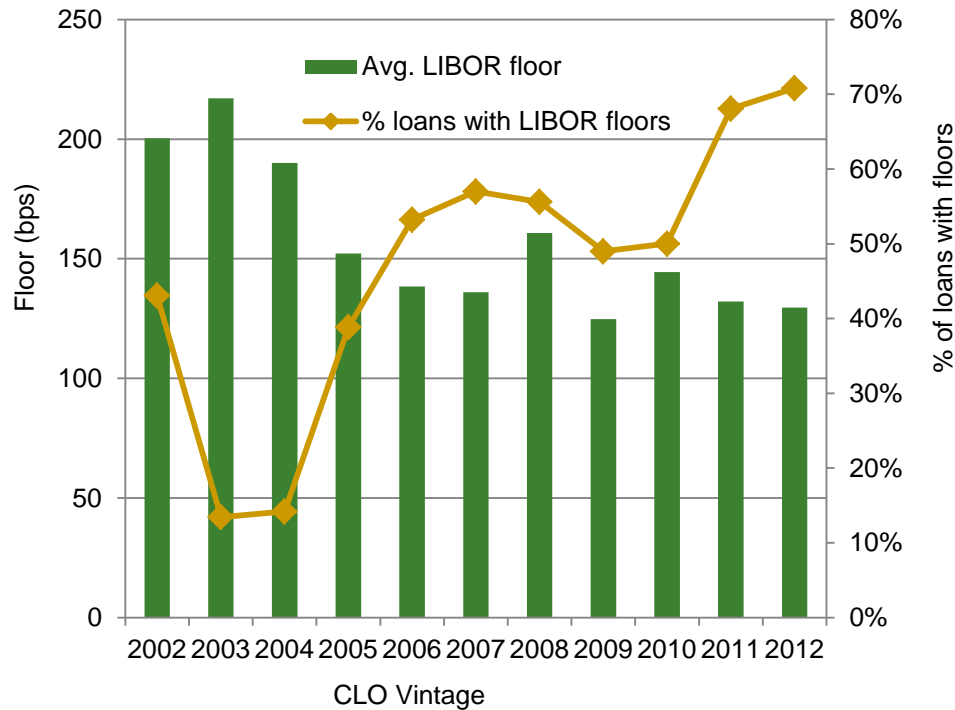
Hedge funds/HY/RV accounts play small role in higher rated (lower yielding) loans



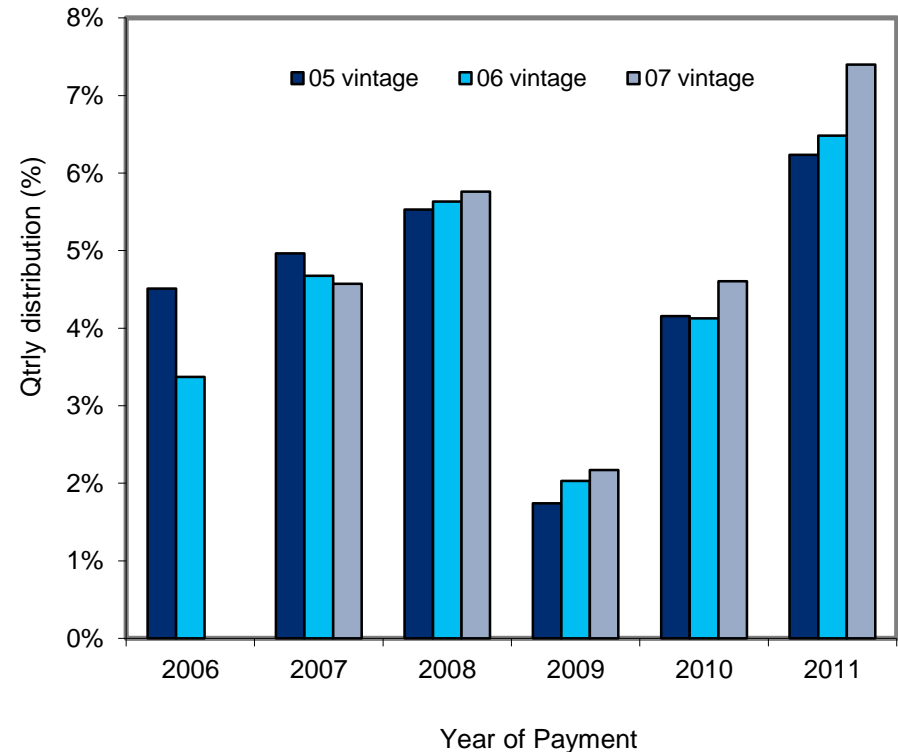
Source: S&P/LCD

LIBOR floors have supported CLO equity performance ...will they stick?

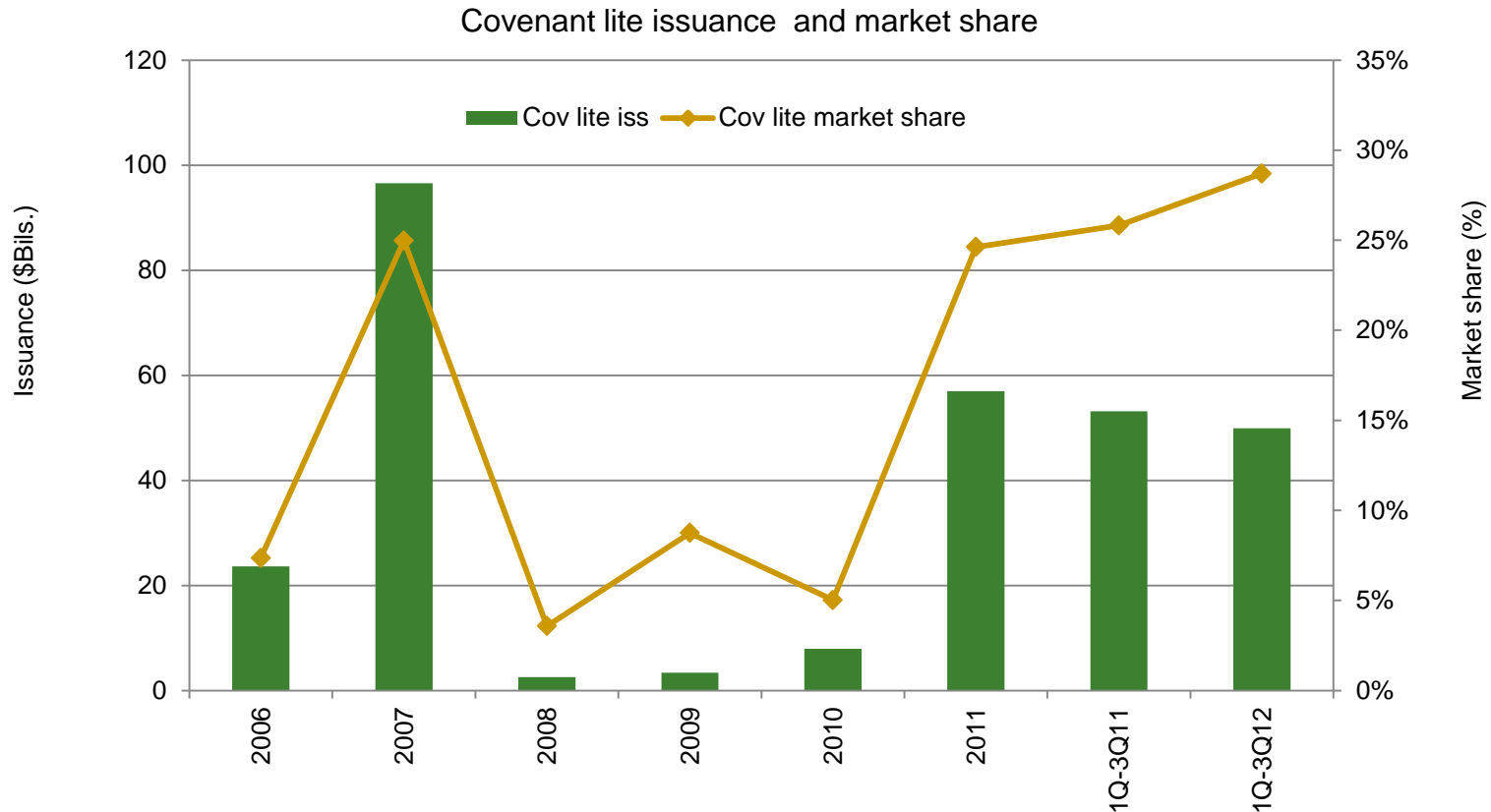
LIBOR floors are widespread ...



...Supporting strong quarterly distributions in CLOs



Covenant lite loans return... but will new CLO constraints limit the cov-lite market?



Source: S&P/LCD



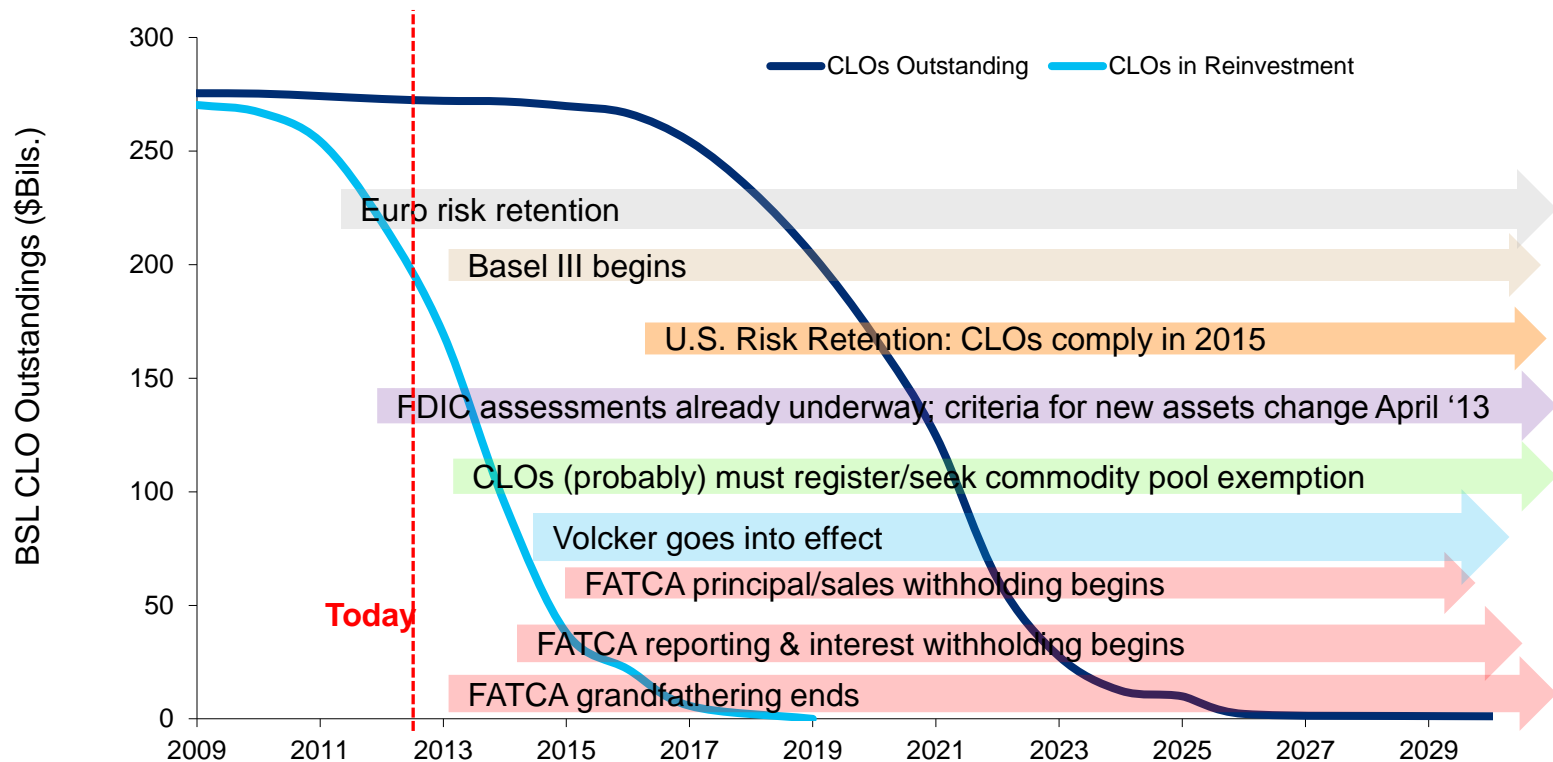
Section IV: CLOs and Regulation

- Risk retention...
- And FATCA...
- And Volcker Rule...

OH MY!

Regulation and existing CLO lifecycle

Outstanding and reinvesting CLO s vs. looming regulation



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