

Takeaways From ABS East

CLO Experts Strike a Note of Caution

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Morningstar Perspective

It seems all but certain that the members of the Federal Open Market Committee will emerge from their meeting on Wednesday announcing another interest-rate hike, which will further add to collateralized loan obligations' popularity. The rising interest-rate environment is just one reason why CLOs, which have floating interest, are attractive to investors. On Sunday, Sept. 23, at the ABS East conference in Miami Beach, participants in a panel on CLOs discussed the reasoning behind the uptick in CLO issuance and some concerns to look for in the years ahead.

Rachel Russell, managing director at Morgan Stanley, said that CLO issuance is \$210 billion for year-to-date 2018, up from \$196 billion the same period last year. And it's not just the volume. She added that the number of investors is growing as well. This year, Morgan Stanley worked with over 200 investors of the AAA rated bonds at the top of the capital stack, up from less than 40 in 2012.

Most of the increase in total CLO volume has come from a huge spike in CLO resets. Russell mentioned that resets have reached \$91 billion so far this year, up from \$32 billion a year ago. Resets extend a CLO's life cycle, as managers make changes to an existing special-purpose vehicle. For example, managers could adjust the bond yields, extend the loan terms, redefine the eligibility criteria, and so on. In a sense, the resets act as permanent capital, allowing managers to keep assets rather than creating replacements. When looking at new issuance and resets alone, the increase is 70% between this year and last year, according to Russell. Previously, there were more refinancings, but the repeal of risk retention for CLOs earlier this year has made resets the more popular choice. Russell estimates that there are \$24 billion in CLO refinancings for year-to-date 2018 versus \$80 billion for year-to-date 2017. Looking ahead, Russell believes CLO issuance will remain active for the rest of the year, but supply will be moderated next year. She doesn't expect as many resets.

With the increased interest in CLOs, there are inevitably some concerns. Morningstar Credit Ratings, LLC's John Nagykey, assistant vice president of ABS, said, "There has been some pushback recently, but overall, loan documentation is weaker, spreads

have compressed quite a bit over the last few years, and there's further evidence that new borrowers coming to the market for the first time [are] coming with much weaker credit [than] in the past." He went on to observe that this year is on track to be a record year for new borrowers bringing to the market loans that are rated B- or below. Managers are trading that collateral at or above par right now, but it is still subject to volatility.

Vincent Ingato, senior portfolio manager at ZAIS Group, agreed that downgrade risk is a big concern. He said, "About 40% of all the loans issued in 2018 were rated B or B- by S&P or B2 [or] B3 by Moody's. That's not very far from CCC." There are limits to how much of the collateral can be rated at the CCC level, and any future downgrades could push CCC rated collateral above that limit, thereby causing discounts to the collateral.

In addition, some managers are trying to get more aggressive terms in their loan documentation. Nagykey highlighted some examples, including excess par leak allowing long-dated assets, changing definitions on various terms such as what counts as a covenant-lite loan, and tweaking calculations on items like weighted average spread and the overcollateralization test. In a mild economy, like the current one, it's not much of a concern. However, Nagykey did say, "These features can enable or worsen the next crisis. . . . At Morningstar, we are keeping an eye on these directly, and we are going to apply additional stresses as we see these features come into play."

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