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Innovative Alternative Structures Pop Up in the CLO Market

May 23, 2019

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Morningstar Perspective

Stagnant interest rates, lack of significant cross-over investors, and downward ratings migration in the loan market are spurring innovation in CLO structures. Ryan Suda, partner at Mayer Brown LLP, acknowledged this during the innovation panel he led at Information Management Network's Investors' Conference on Collateralized Loan Obligations and Leveraged Loans on May 21 in New York. According to a live audience poll, many session attendees (42%) felt that innovation must address the level of equity returns in order to produce the most benefit to the CLO market. Across various alternative structures, including applicable margin resets, or AMRs; modifiable and splittable tranches, or MASCOTs; static CLOs; structures with a high CCC component; and collateralized bond obligations, or CBOs, 32% of session attendees identified AMRs as having the most staying power, regardless of market conditions. The high CCC structures, CBOs, and to some extent static CLOs seem more opportunistic in nature.

Serhan Secmen, managing director at Napier Park Global Capital, noted that both the need for innovation and opportunity are driving change. The need derives from a mismatch in the market between investors and the respective returns they are getting. Against the backdrop of a relatively stable market with stagnant interest rates, this desire for yield is creating an opportunity for new CLO structures to enter the market. According to Secmen, innovation is about "followership." Attracting a second person may not be enough; getting a third person draws a crowd.

John Nagykery, team lead of CLOs at Morningstar Credit Ratings, LLC, responded that, "Innovation breeds opportunity because it allows managers and deal arrangers to stand out." He noted that postcrisis, the CLO market has had its ups and downs for both debt and equity investors, yet it has always rebounded and found a way to maintain high issuance volumes. This has primarily been the result of minor structural tweaks rather than innovations, including step-up coupons, playing with the non-call periods, and zero or short reinvestment periods. Step-up coupons, where the interest rate paid to AAA investors increases over time, have not been as successful, while some managers have been attracted to shorter non-call periods because it allows them the flexibility to reprice and capitalize on interest rate changes. However, as CLOs have become more commoditized, it has taken time to create and work through the nuances of new structures. Arrangers and managers not only invest time in creating such structures, they also face reputational risk should their new products fail.

Being an early adopter of these new structures has its benefits, according to Olga Chernova, chief investment officer at Sancus Capital Management. Chernova noted that the "newness premium" can be very valuable and attractive because those who are first in are often well compensated. In 2019, the CLO arbitrage disappeared, and newer structures focused on getting equity returns back to double-digits. She said that while AMR was born out of trying to address risk retention, it accidentally became an innovation by embedding the auction procedure in the original indenture. In addition, the AMR mechanism also cuts refinancing costs significantly. The challenge will be gaining widespread acceptance because to date only five transactions have deployed AMR. Use of the mechanism has some momentum though according to Chernova, who stated that although Bank of New York Mellon was initially the only trustee on board, many more have since jumped on the bandwagon.

Larger CCC buckets are another key market innovation. Andrew Curtis, managing director of Z Capital Partners, LLC noted that three managers have issued six deals, where 50% of the assets can be CCC, without any haircuts. The outsize CCC bucket structure affords managers enormous flexibility, while giving debtholders absolute spread and enhanced subordination. Curtis emphasized, however, that because this flexibility is extraordinarily powerful, it's important to exercise extreme care in creating the CCC structure. While managers can exploit dislocations in the senior loan market, ratings deterioration and negative migration are also likely, so managers need to be comfortable investing in distressed situations.

Ankit Aggarwal, head of U.S. CLO structuring at Bank of America Merrill Lynch, followed up by discussing the marketability of these new products. Aggarwal said, "These structures are a good way for equity investors to deploy their capital for long-term optionality." He speculated that perhaps some may look at a 20% CCC bucket versus a 50% bucket. Curtis questioned whether there would be enough pick-up, or an improvement in pricing, in liability costs if the CCC bucket were compressed. Secmen noted that the enhanced CCC structure won't work if they account for most of the market. The "hot sauce" loses its kick if everyone utilizes the same outsize bucket. Nagykery expressed concern that if a surge of cash rushes into the market with inexperienced managers looking at these outsize CCC buckets, it might lead to the "precipice for a potential disaster."

The panel also touched upon CBOs and MASCOTs. Aggarwal noted that with 60% of the investment-grade corporate debt market at BBB, 25% getting downgraded would present an enormous opportunity for CBOs. CBOs are backed by collateralized bonds, as opposed to loans, and they are generally more easily transferrable because the bonds are marketable securities. But Nagykery noted that we might stay in this "seventh inning" and these "opportunistic" times may not come around. About eight or nine CBOs and a handful of MASCOTs have come to market so far. The MASCOT structure allows a single investor to purchase different combinations of principal-only and interest-only notes.

Although the consensus among the panelists seemed to be that market innovation will continue to flourish as arrangers seek to satisfy current investor demands by creating bespoke structures, participants also emphasized that these structures are not intended to replace the traditional CLO structure.

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