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Profiling European leveraged loan CLO managers

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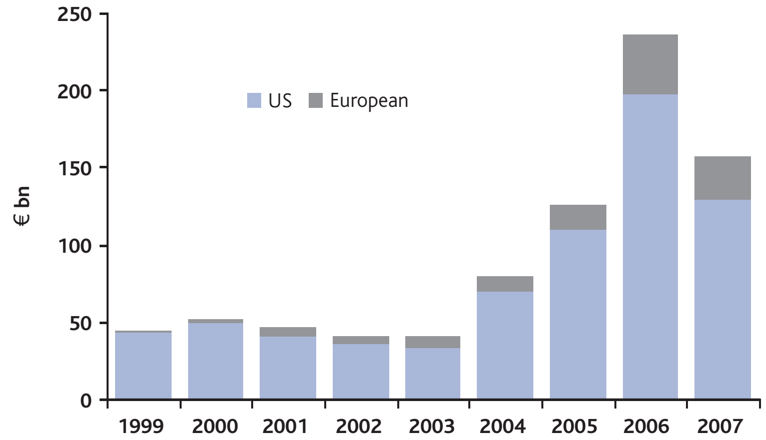
Despite the credit market turbulence, 2007 was yet another record year for European leveraged loan collateralised loan obligation (CLO) issuance. This chapter looks at the development of the European leveraged loan CLO market from the perspective of CLO managers.

The global high-yield CLO market continues to be dominated by US product, with the European market share standing at 18 per cent of global CLO volumes in 2007. However, growth of the European CLO market has been more spectacular in recent years – the market grew by 193 per cent in 2006 (some €34 billion, as a case in point, moderating only slightly in the credit-crisis dominated 2007 (to €27 billion, still some 135 per cent ahead on 2005 volumes). Indeed, the CLO market in Europe has grown appreciably since the very first deal in 1999, brought by Intermediate Capital Group. Growth of the European CLO market has mirrored the development of the underlying market in leveraged loans, which itself has grown from just €35 billion in 1999 to €165 billion by the end of 2007, according to Standard & Poor's Leveraged Commentary & Data. (In recent years at least, the growth of the leveraged loan market has been fuelled by the private equity-driven LBO boom.) Unlike the United States, where collateralised debt obligations (CDOs) of asset-backed securities (ABS) dominate, the European CDO market is heavily biased towards leveraged loan product, which accounts for 82 per cent of outstanding cash CDO volumes, with CDOs of ABS and commercial real estate CDOs making up the balance. Amid the credit crisis, volumes in the fourth quarter of 2007 dropped dramatically, with issuance limited to legacy warehouse CLOs.

Figure 1: Global cash managed CDO volumes

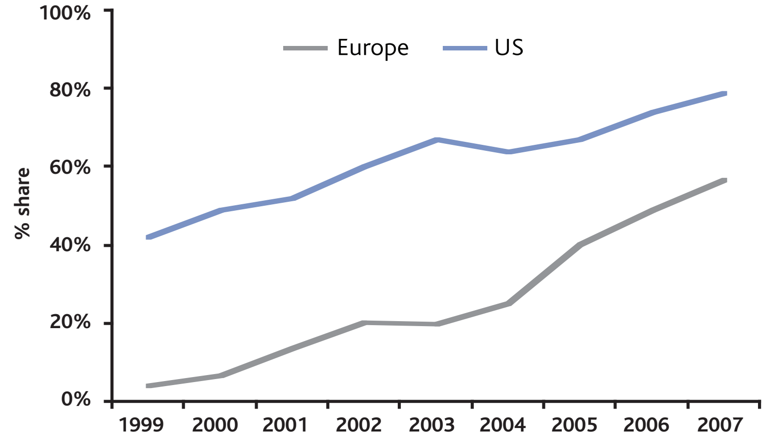


Source: Deutsche Bank Global Markets Research

Recent trends in the CLO manager market

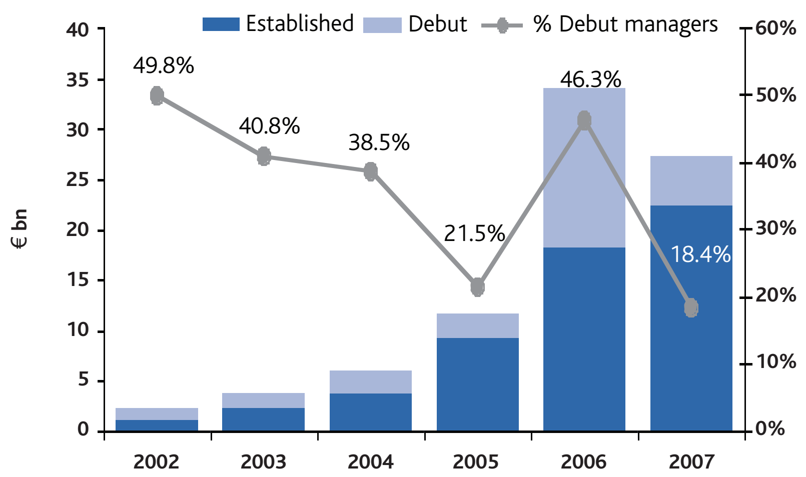
Testament to the recent remarkable growth of European CLOs, the bulk of the market outstanding (85 per cent) comprises post-2005 vintages. On our count, there are currently €84 billion of European leveraged loan CLO volumes outstanding, based on 203 deals managed by 58 loan investors. Of these managers, we consider 52 to be programmatic CLO issuers – that is,

Figure 2: CLO share of leveraged loan markets



Source: S&P LCD

Figure 3: European CLO primary market volumes – debut v established managers



Source: Deutsche Bank

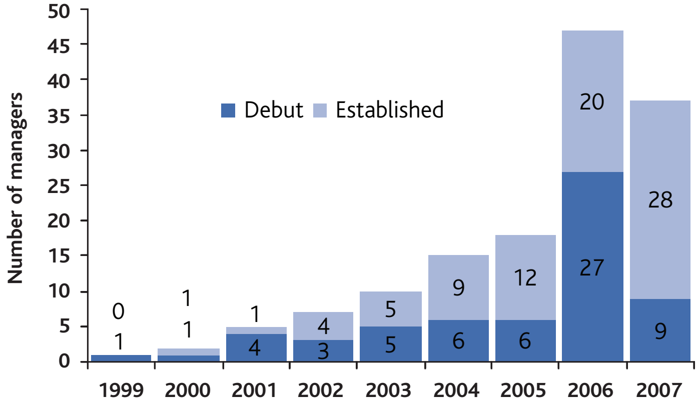
those that have come to market at least once since the beginning of 2006. The top 10 managers in the European CLO market account for €43 billion (or 52 per cent) of volumes outstanding.

In line with the growth of the European CLO market, CLO managers have become a very important investor constituency in the underlying leveraged loan market. Banks still dominate the European leveraged loan lending market (with a circa 50 per cent market share, according to Standard & Poor's), but CLO managers have muscled a steadily increasing market share in recent years and currently account for circa 38 per cent of the European leveraged loan investor base. The recent market turmoil has seen loan price declines follow on the heels of CLO spread widening, thus evidencing the pricing relationship between the asset and funding markets which in turn underpins, we believe, the importance of CLOs as lenders in the European loan market.

One of the most defining trends in the European leveraged loan market in recent years has been the proliferation of managers. From a more fundamental perspective, the significant increase in the number of CLO managers in recent years has been underpinned by the attractive risk-reward opportunities in the leveraged loan market, coupled with the efficiency of using CLOs as a means to finance and grow assets under management while leveraging equity returns. Indeed, the ready, cost-effective liquidity provided by the structured finance market in recent years has arguably been the key factor behind the proliferation of the CLO manager base.

From the market's inception in 1999 until 2004, managers were relatively few in number, with repeat issuance from established platforms such as Intermediate Capital Group, Alcentra, Duke Street Capital (acquired by Babson), M&G Investment and Avoca Capital accounting for the bulk of deal flow. The most significant influx of debut managers occurred in 2006, as 27 inaugural CLO programmes came to market via €14.5 billion of volumes, compared with just €2.5 billion in new CLO manager issuance over 2005. The depth of the CLO manager base almost doubled in 2006, bringing the total number of managers that have tapped the European CLO market to 58 currently.

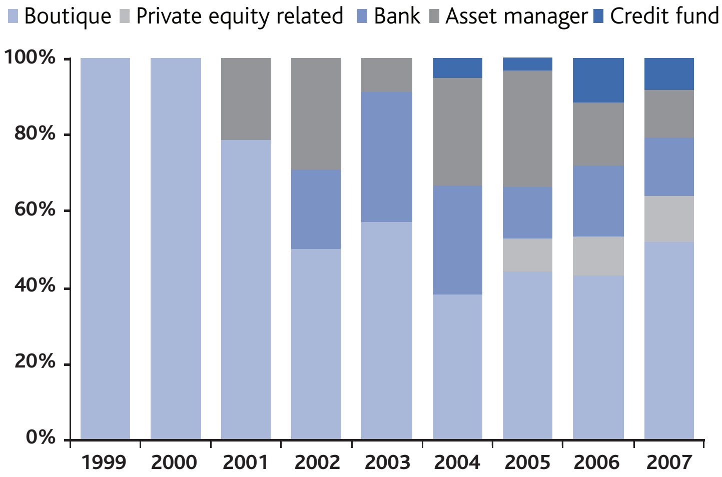
Figure 4: European CLO primary market manager count – debut v established



Source: Deutsche Bank

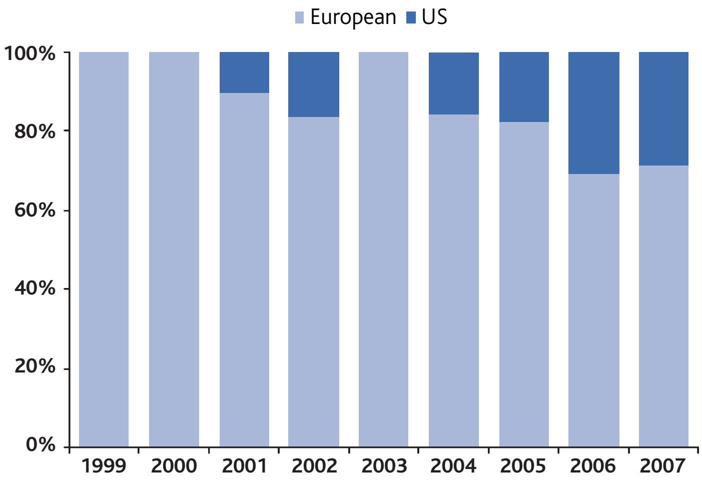
Looking through the recent proliferation of the European CLO manager base, a number of noteworthy trends are observable. The first is the greater diversity of manager types in recent years. Once the preserve of loan market boutiques, the market has evolved to encompass a broader base of CLO managers, including banks, traditional asset managers, private equity-related loan platforms and credit funds. The second notable trend has been the significant influx of US managers, most of which are established US loan and/or high-yield specialists looking to build out their businesses on a more global scale. Oakhill, Sankaty Advisors, Eaton

Figure 5: European CLO primary volumes by manager type



Source: Deutsche Bank

Figure 6: European CLO primary volumes by manager domicile



Source: Deutsche Bank

Vance and Ares Management count among such US-domiciled CLO managers venturing into the European loan market in the past year or so. The other trend in recent years that we would highlight is the emergence of loan investors or CLO managers that we would deem to be the more 'opportunistic' issuers. By this we mean the few CLO platforms that have surfaced since 2005/2006 primarily to exploit the asset-liability arbitrage – that is, the yield gap between leveraged loans and CLO bonds. Identifying such opportunistic issuers is not straightforward, but almost by definition such CLO managers would typically be newly initiated platforms rather than established loan market business models, and are also likely to be heavily reliant on the CLO market for funding. The potential lack of technical/credit expertise and experience, and a less demonstrable commitment to the loan market among such managers, are key risk considerations for CLO investors, in our view. Indeed, some of these smaller platforms (particularly those with three CLOs or less) are likely to face significant business model challenges in a more difficult CLO issuance environment.

Outlining the different manager types

The preceding credit bull run has made it difficult to compare and contrast manager skill-set and abilities – alpha generation has not been particularly observable, given the recent broad-based rally in both the loan and CLO markets, which in all likelihood has also served to bail out any weak asset selection practices. Still, CLO manager business models and operating structures vary somewhat, as does the degree of access to primary collateral. However, from what we can tell, investment and credit processes seem less distinguishable, at least in the current market. (We emphasise again that weak credit management is likely to become more apparent only in a downturn.) Generally, analysts conduct the initial research on loan deals shown by syndicates and present the underlying credit assessments (which would normally cover operating, financial and structural analysis of the loan borrower) to the portfolio managers. The analysis usually also incorporates corporate cash-flow stress runs in order to size the borrower's ability to repay debt in various scenarios. Subject to the funding being approved, the loan will then be subject to postdeal performance monitoring whereby regular management reports and other (often private) information relating to the leveraged loan is periodically studied and contrasted with base case scenarios.

Generally speaking, the European banks and established asset managers typically have a higher staff-to-asset ratio compared to the more specialist leveraged loan manager. All CLO managers have staff resources dedicated to the loan credit underwriting and management process, ranging from credit analysts performing due diligence on underlying credits to portfolio managers involved in asset selection and surveillance/monitoring analysts to dedicated work-out specialists in some cases. Some differences lie in how employees are allocated to each of these functions, however. Below, we summarise the profile of some of the major CLO manager-types:

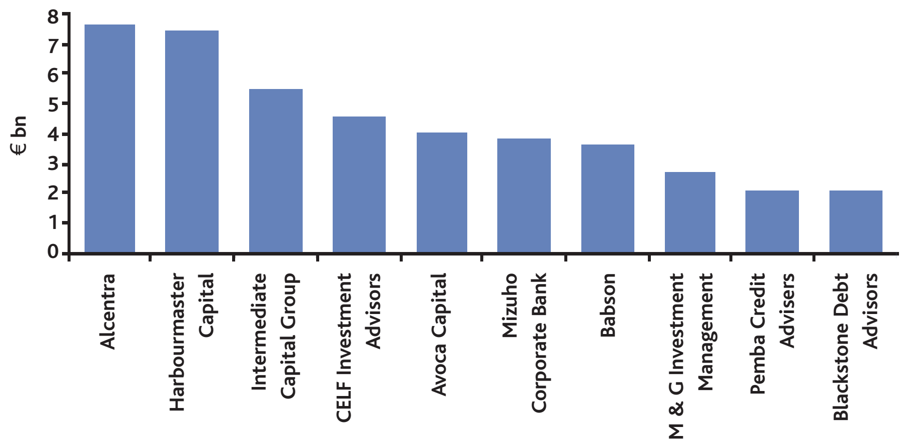
- Banks typically arrange, co-lead and participate directly in loan syndications; however, a bank's CLO business is normally (with few exceptions) independent of the acquisition finance team which is responsible for originating loans. The CLO team typically underwrites loan credit autonomously from the bank, though often the CLO business is able to draw on the resources of the bank's acquisition finance team. An entirely separate surveillance team is usually responsible for monitoring the performance of the bank's overall loan credit exposure. Bank leveraged loan CLOs can also include the more opportunistic issuers we outlined above, with such deals often related to the funding or hedging of trading desk inventories.
- The asset manager model is generally similar to that of a bank in that they normally have a dedicated credit investment team responsible for looking at leveraged loan/high yield credit as part of the product specialisation model of the business. However, it is not uncommon to see a more centralised research function, with analysts covering loan or high yield credits for a variety of funds within the asset management business to include, say, the life funds, mezzanine funds, private mandates and the CLO team as well. The traditional or more established long-only asset managers have in most cases used CLOs as a tool to leverage their existing loan businesses. However, we note that there are a few cases where asset managers have opportunistically taken advantage of the cost-effective liquidity in the structured finance markets to build out leveraged loan investment franchises.
- Loan investment boutiques – an all-encompassing term we use to describe specialist loan managers – are generally based on a more focused or streamlined operating structure. Portfolio managers normally work directly with a team of credit analysts responsible for loan credit appraisal and performance monitoring. Unlike banks or larger asset managers, credit analysis is most often focused directly on underwriting loans earmarked for CLOs, with such assessments also taking into account portfolio guidelines and other parameters dictated by the CLO (rating agency-based) model. Naturally, the number of credit analysts and investment managers typically number less in a boutique compared to a bank and asset manager.

European CLO market outlook

The recent sharp credit market correction, which also triggered an unprecedented sell-off in the leveraged loan market, is likely to cause a disruption to CLO deal flow in the near term. Pending CLOs, or essentially bank warehousing lines that have yet to secure term capital market funding, face both asset valuation write-downs and risks of further widening in CLO exit funding costs (to include the risk of no equity take-up), with related losses borne either by manager equity and/or by the arranging bank. Many such warehouses are likely therefore to be liquidated with related deals pulled.

However, we remain optimistic that CLO deal flow will resume once credit markets normalise. To be sure, the economic viability of CLOs going forward will depend on where asset and liability spreads stabilise in the aftermath

Figure 7: Top 10 European leveraged loan CLO managers by bond volumes outstanding



Source: : Deutsche Bank Global Markets Research

of the current crisis, but our point is that loan spreads can no longer be entirely de-linked from CLO funding costs (given the dominant role of CLOs as investors in the loan market); so the asset-liability spread gap, and therefore the economic viability of CLO models, should be naturally re-established once pricing normalises, whenever that may be. (The risk to this view is that banks fully re-intermediate the leveraged loan market post-crisis, leaving CLO managers completely priced out of the loan market.) But the current credit crisis will surely serve to dampen (perhaps significantly) the recent explosive growth in the loan and CLO markets, and thus we expect lower deal volumes in the foreseeable future.

Not only has the recent credit market turmoil resulted in costlier funding for the European CLO market, but investor demand for CLOs is likely also to be more selective going forward. A greater tiering of leveraged loan CLO quality, whether measured by collateral type or structural profile or indeed manager attributes, can therefore be expected, with weaker outliers likely to be penalised. (Such outliers may also of course be identified by relative credit under-performance in any downturn.) We believe the newer, less experienced platforms are most at risk in this respect, as are loan businesses which are overly dependent on achieving a certain scale in terms of assets or CLOs under management for survival. (One could also argue that such CLO management novices only exist because of the structured finance liquidity bubble of recent years.) Any CLO manager 'shake-out' should benefit the stronger incumbent players, however – not least given the opportunities for takeovers and consolidation, in our opinion.

This chapter is taken from previously published Deutsche Bank research.