Fair Oaks Capital

Reflections

October 2018

CLO Equity: A Good Time to Invest?

Challenging credit fundamentals, tight credit spreads and volatility can, unsurprisingly, be reasons to justify delaying investment decisions until the market corrects. On the other hand, the opportunity cost of holding cash is high and it is difficult to time investment decisions perfectly, not just in the sense of identifying the right time to invest but also ensuring decisions are made in a timely manner at a time of high volatility. Fair Oaks believes that CLO equity provides a compelling solution to the aforementioned challenges, particularly for investors with a medium-term time horizon. In addition to offering an attractive return under sensible default and reinvestment assumptions (we estimate that the base arbitrage for a typical CLO is in the 10–12% range), there are unique characteristics of CLO equity that significantly mitigate concerns of weak credit fundamentals and tight credit spreads while CLO equity also has an unusual positive exposure to volatility. The historical return experience for CLOs, particularly for CLOs issued just before the financial crisis, further makes the case for investors to consider the asset class in current market conditions.

Challenging Credit Fundamentals

Strong global economic growth and low interest rates have contributed to relatively low corporate default rates in the US and Europe in recent years and a benign default rate outlook. Unfortunately, the resulting investor demand for loans has led to a weakening of lending standards. Although sometimes disguised by EBITDA adjustments, leverage on new issue loans has been increasing. Meanwhile, loan documentation has become weaker, not just by being cov-lite but also by incorporating significant flexibility for private equity investors to increase debt and pay dividends.

	Leveraged loans[1]	CLO[2]	Fair Oaks investment[3]
Default rate	2.0%[4]	N/A	0.2%
% CCC+ and below	6.5%	3.7%	2.8%
Priced below <80	1.8%	0.9%	0.8%
Average loan price	97.9	98.5	98.8
% Retailers (except food & drug)	4.5%	4.4%	3.6%
% Commodities	4.6%	3.6%	2.7%

Figure 1: Comparison of CLO portfolios and loan market

Fair Oaks' view is that despite these weaker credit fundamentals, senior secured loans offer one of the most attractive relative value opportunities in the credit markets and it is still possible to construct diversified portfolios of higher quality loans. CLO documentation imposes strict limits on the credit ratings, recovery ratings, diversity and company size in a CLO loan portfolio. As a result, CLOs tend to have a higher average quality than the broader loan market, along with lower exposure to distressed and lower-rated assets (see Figure 1).

Tight Spreads

Spreads in most credit markets have tightened in recent years as investors have chased yield in a low interest rate environment. Senior secured loans are no exception, as can be seen in Figure 2. However, the return on CLO equity is not impacted solely by loan credit spreads but by the difference, or arbitrage, between loan spreads and CLO liability spreads. Demand from new investors in the CLO liability market has driven down the cost of CLO debt funding, particularly AAA notes, and the arbitrage remains attractive for CLO equity investors.

	First CLO control equity Investment	Latest CLO control equity investment
Trade date	Aug 14	Aug 18
Initial average loan portfolio spread	3.75%	3.39%
Difference vs 2014		(-36bps)
AAA Spread	1.55%	1.15%
AA Spread	2.10%	1.13%
Weighted average cost of funding	2.30%	1.71%
Difference vs 2014		(-60bps)

Figure 2: Asset and liability spreads in Fair Oaks' first and most recent CLO equity investments

1 LCD, an offering of S&P Global Market Intelligence, June 2018.
2 Citi Research, Citi US CLO Scoreboard July 2018.
3 Reflective of all CLO equity investments made across Fair Oaks Capital funds. Source: Intex, as at August 2018; Fair Oaks Capital as at June 2018. Default rate based on a four year cumulative default rate annualised; % CCC+ and below, based on 18 of 22 investments where balances are disclosed; % Commodities composed of the sum of Oil & Gas, Steel and Nonferrous Metals/Minerals exposure by S&P Industry classification.
4 Last twelve months default rate of the S&P/LSTA Loan Index as at 31 August 2018.

Potential for Volatility

Fair Oaks believes that the combination of high equity valuations, relatively tight credit spreads, rising interest rates, geopolitical risks and the restrictions on banks' market-making abilities creates significant potential for volatility in financial markets. It is of course difficult to consistently generate yield without exposure to equity valuations, credit spreads or interest rates. CLO equity offers an interesting investment opportunity as a floating-rate investment which combines arbitrage of credit spreads, discussed above, with a positive exposure to volatility. Long-term, non-mark-to-market financing allows CLOs to take advantage of loan market volatility as CLOs can invest loan repayments or loan sale proceeds in new, wider-spread loans, improving the arbitrage for CLO equity. While it may be counterintuitive that loans would be prepaid in a widening spread environment, there are reasons which could make this optimal or required for a company. These include mandatory prepayments upon a sale, refinancing to fund acquisitions, refinancing of loans with bonds and, importantly, refinancing with longer-dated loans as maturities approach. The 15.7%[5] average repayment rate in 2009 illustrates the continuance of loan prepayments even in weak market conditions.

Investment Timing

The heightened potential for market volatility also raises the question of whether it is advisable to wait for a better entry point. For CLO equity, a very opportunistic approach with respect to investment timing can be rendered impractical by unavailability of opportunities. Valuations may, at times, be volatile but since the financial crisis most CLO equity investors favor maturity-matched vehicles (long term or even permanent capital) which tend not to be forced or panic sellers. The market volatility of Q1 2016 is a good case study. As Figure 3 shows, CLO valuations were very volatile and, in theory, it would have been the right time to invest in CLO equity. The actual opportunity to buy or originate CLO equity at the time was, however, limited. CLO equity on offer via BWIC[6] in January, February and March 2016 was only $113m, $23m and $64m respectively, versus an average monthly volume of $244 million in 2015 and $270 million in 2014.

Originating new CLO equity to take advantage of weak loan prices would also have been ineffectual. The spread for the BB subsector of the Credit Suisse Institutional Loan Index, which we think is a better proxy for the loans a CLO would have acquired (avoiding stressed and distressed names), widened 0.12%, from Libor+2.96% at the end of Q3 2015 to Libor+3.08% at the end of Q1 2016. In the same period, CLO AAA spreads widened 0.14%, from Libor+1.54% to Libor+1.67%[7], making the potential arbitrage less compelling. It is also worth noting that, even at the wider CLO financing spreads, the CLO new issue market was effectively brought to a halt given a lack of AAA investor demand.

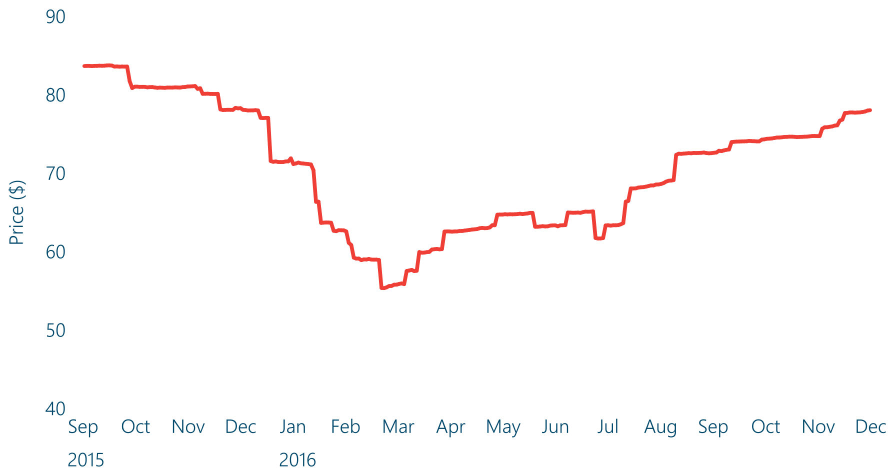

Figure 3: JP Morgan CLOIE B Rated CLO Index (price)

There were two US CLOs priced in January 2016 ($0.83 billion) and six in February 2016 ($2.55 billion[8]) compared to an average of 16 CLOs priced per month in 2015 (or $8.2 billion per month[9]). So while an investor who allocated capital to CLO equity in 2015 would have benefitted from low cost of CLO financing and wider loan spreads in 2016 as it reinvested loan prepayment proceeds, we believe a "wait and see" investor would likely have been unable to acquire CLO equity in the secondary or primary markets.

5 S&P LCD, annual S&P/LSTA Index Repayment Rate.
6 Bids Wanted In Competition, effectively public auction of securities.
7 JP Morgan CLOIE AAA post crisis index.
8 S&P Global Market Intelligence.
9 JP Morgan.

CLO Equity Return Experience

What can be observed from the charts in Figure 4 is that CLOs from the 2005–2007 vintages delivered stronger returns than those just after periods of market correction (2003–2004 and 2010–2013). In Fair Oaks' view, this was largely a result of the attractive CLO financing costs locked in by CLO equity investors during 2005–2007 and the subsequent benefit of loan spread widening.

In conclusion, we believe that investors with a medium-term investment horizon can generate an attractive base case return by investing in CLO equity today, supported by relatively high quality loan portfolios and a relatively low cost of CLO financing. At the same time, they will enjoy a structure whose long-term funding will allow them to take advantage of potential loan price volatility. Although the CLO equity position may experience bouts of short-term volatility in its valuation, we believe the expected returns more than compensate for this. The return drivers of CLO equity and its investor base also mean that waiting for a bout of volatility to present an opportune entry point may not be either necessary or practical.

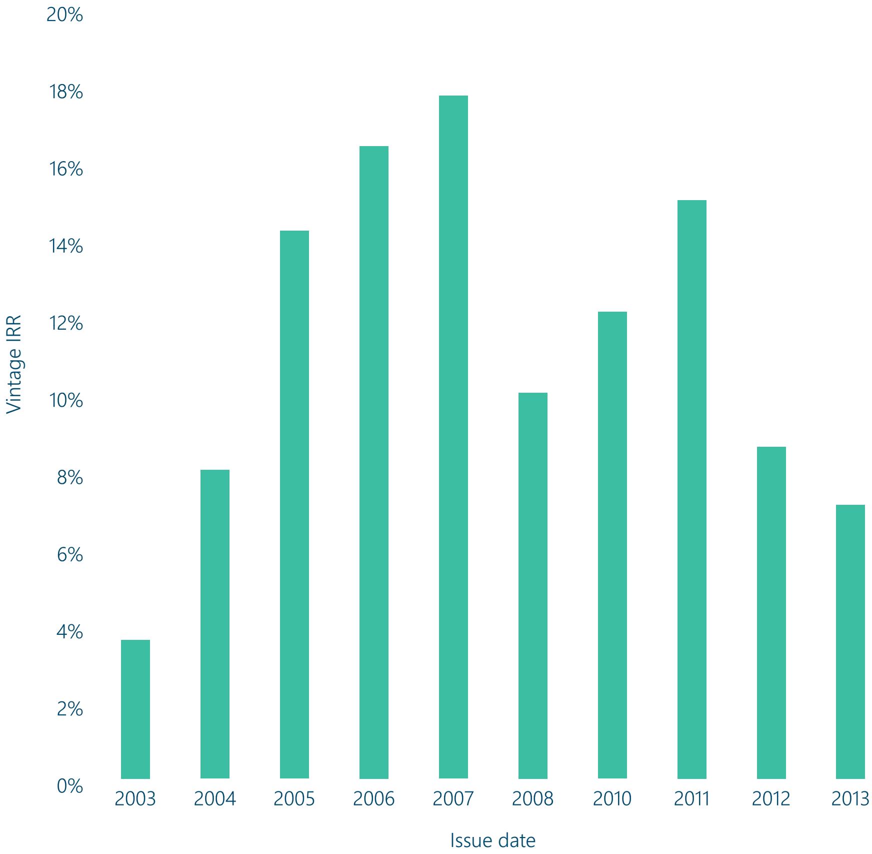

Figure 4: Median IRR by year of issue[10]

Fair Oaks also believes the CLO origination process offers significant opportunities to add alpha beyond the base case. Significant involvement in the original portfolio selection and ongoing monitoring of underlying bank loans, independent negotiation of financing structures, and optimal and independent exercise of control positions to refinance or call the investments may further enhance the base return.

10 Wells Fargo Securities; data as of Q1 2018. Data based on completed deals – assumes equity purchase price at par.

2013

Fair Oaks was established by former senior investment professionals of GSO/Blackstone and Stone Tower Capital

$2.2 bn* AUM

Fair Oaks is an independent asset management firm focused on the global corporate credit markets

ESG

As a UNPRI signatory, Fair Oaks Capital Limited is committed to applying the principles to all investment criteria and increasing awareness in the CLO market

18*

Strong team of fundamental credit specialists, supported by experienced legal, compliance and investor relations staff

5 funds*

In a number of structures, including UCITS, LPs and listed Investment Trust on the Specialist Fund Segment of the London Stock Exchange

FCA:SEC

Fair Oaks is regulated in both the UK and US and applies strict quality control and compliance monitoring†

*As at 31 August 2018.
†Fair Oaks Capital Limited is (i) regulated by the Securities and Exchange Commission as an Investment Adviser; and (ii) authorised and regulated by the Financial Conduct Authority in the United Kingdom. Fair Oaks Capital US LP is regulated by the Securities and Exchange Commission as an Investment Adviser.

FAIR OAKS
CAPITAL

Fair Oaks Capital US LP
152 West 57 Street
New York, NY 10019
+1 212 973 8200

Fair Oaks Capital Ltd
1 Albemarle Street
London W1S 4HA
+44 (0) 20 3034 0400

IR@fairoakscap.com
fairoakscap.com