

MARKETS & INVESTING

FT Series. The Debt Machine

Investors flock to CLOs with ghost of previous loan vehicles left in the past



How collateralised loan obligations work

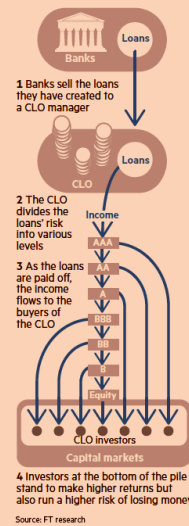


Illustration by Adam Simpson

Higher protection means risk is far lower than with CDOs, according to industry experts

JOE RENNINGER — NEW YORK

Wall Street's debt machine is being powered by a familiar engine: securitisation.

As scrutiny of the \$1.2tn leveraged loan market has increased, focus has turned to the market's main source of support: so-called "collateralised loan obligations".

CLOs are vehicles that take a group of risky loans and use them to back a series of bonds of varying degrees of safety.

Investors in the most perilous, lowest-rated "tranches", as they are commonly known, are rewarded with higher returns but are hit first if the underlying loans — issued to low-rated or heavily indebted companies across the US — begin to default.

As such, CLOs resemble other structures that rocked the financial system a decade ago, such as "CDOs" (collateralised debt obligations), which issued debt backed by bundles of (what turned out to be) junk mortgage bonds. But both investors and CLO managers say this time is different.

"[CLOs] begin with a 'C' and end with an 'O'," said one investor, adding that parallels should end there. "Overall, the

asset class has proved resilient across several market cycles."

The record is certainly encouraging. Of the 4,522 CLO tranches that were rated by S&P Global Ratings before 2008, only 38 tranches across 22 CLOs have defaulted, notes LCD, a division of S&P Global Market Intelligence. And there has never been a default of a triple A-rated tranche.

But the market has grown a lot since then. The value of outstanding CLOs has doubled since 2007 to more than \$600bn at the end of 2018, consistently representing about 50 per cent of the investor base for leveraged loans, according to data from Citigroup.

Some protections have increased, too. On average, a CLO would have to experience losses in excess of 35 per cent before triple A investors would lose money, according to Fitch Ratings. That is up from an average of about 25 per cent before the financial crisis — the result of rating agencies changing their recovery assumptions for the underlying loans, while setting a higher bar for CLO managers to reach that triple A rating.

"We wanted to make sure that the triple A-rated notes are protected," said Kevin Kendra, head of US structured credit at Fitch.

Those structural changes mean that CLOs concentrate the risk of losses in the hands of a small group of hedge

funds and other investors with a high tolerance for big swings in performance.

Already, strong demand from CLOs has helped to shored many of the investor protections that were once routinely embedded in loan documents. Financial maintenance covenants — contractual agreements that would limit the amount of leverage a company could take on, or mandate thresholds for the amount of cash they needed on hand to pay interest on their loans — have been eroded.

That means that when a downturn comes and borrowers start to hit trouble, losses for loan holders could be greater than they had imagined. That filters through to CLOs, as managers

have less cash to pass through to investors. "I do think credit quality has deteriorated," said Jeanne Manischewitz, a partner at hedge fund York Capital Management. "Part of that was fuelled by CLO formation."

Another unsettling development for investors: CLO managers have given themselves more flexibility over what they can invest in, such as the ability to fill their vehicles with more second-lien loans, which sit lower down in the capital structure of a company than more senior, first-lien loans.

"We do see some weaker CLO docs in 2018," said Maggie Wang, a CLO analyst at Citi.

"It mirrors the weaker documents in the leveraged loan market." Regulatory standards have weakened, too. At the end of 2016, CLO managers became bound by a requirement that they must hold 5 per cent of the economic interest in each new deal they sell, in an effort to align their interests with those of investors.

But after less than two years, the Loan Syndications and Trading Association, the main industry group, managed to get the rule repealed.

Still, there is little danger of a big blow-up, said Stephen Ketchum, founder of hedge fund and CLO manager Sound Point Capital.

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Fixed Income

S&P Global becomes first foreign agency allowed to rate domestic bonds in China

DON WEINLAND AND EMMA DUNKLEY HONG KONG

S&P Global has won approval from Beijing to start scoring domestic bonds. But becoming the first foreign credit-rating agency to gain entry into the fast-developing Chinese market.

The New York-based company said yesterday that it had been approved by the People's Bank of China to establish a company in Beijing, the central bank said on its website. Under the terms of its licence, S&P is authorised to rate issuers and issuances from financial institutions and corporates, structured finance bonds and renminbi-denominated bonds from foreign issuers, sometimes known as Panda bonds.

The announcement comes as China opens its bond market to international investors and hopes to usher more foreign investment into the country. It also follows months of negotiations with the US and a promise in 2017 to allow in US rating agencies, at a time when the world's two largest economies are locked in a bitter trade war.

Mann George, a bond fund manager at Schroders, said the S&P announcement was "a big deal".

"It will bring international standards into the rating process of domestic

bonds and will encourage foreign investors to look into Chinese corporates in a more serious fashion," Mr George said. "In the longer term, it potentially opens up onshore Chinese corporates to index inclusion." He added that the move should also increase the transparency of the credit rating process.

Paul McNamara, an investment director at GAM, was more circumspect. He described the development as "another marginal improvement" for investors, noting that inclusion of Chinese bonds in indices would be "the Holy Grail".

Over the past two years, regulators



China hopes to usher more foreign investment into the country

have made moves to open up the domestic bond market, including the launch of a so-called "Bond Connect" through which foreign companies can buy onshore bonds through Hong Kong brokerages. Several foreign banks have either been granted onshore bond underwriting licences or have expressed interest in applying for one.

The deregulation comes as China's economic growth is decelerating to levels not seen in nearly 20 years, spurring concerns over capital flight. Regulators have viewed the gradual introduction of foreign capital into the domestic market as a new source of support for asset prices.

One barrier to foreign investment is the lack of foreign ratings on domestic bonds. Investors overseas have long viewed local Chinese rating agencies with suspicion for awarding high ratings to most of the companies they cover.

By letting foreign rating agencies set up in the country, China will be able to demonstrate to the US that it is allowing in more foreign entities.

Fitch Ratings is in the process of seeking an onshore China licence, following the group's sale of its 49 per cent stake in China Lianhe Credit Rating to Singaporean sovereign wealth fund GIC in January last year.

Fixed Income

Goldman among winners as Venezuelan paper gains from possible regime change

ROBIN WIGGLESWORTH AND COLBY SMITH — NEW YORK

The rally in defaulted Venezuelan bonds sparked by hopes of regime change has handed some juicy early-year gains to its biggest creditors, such as BlackRock, T Rowe Price, Stone Harbor and Goldman Sachs Asset Management.

Last week, Venezuelan opposition leader Juan Guaidó declared himself interim president of the country, arguing that the government led by Nicolás Maduro is illegitimate. Subsequently, a host of countries, including most of Venezuela's neighbours and the US, have recognised Mr Guaidó as the country's legitimate temporary leader.

Venezuela has defaulted on almost all its debts since November 2017, and US sanctions mean that negotiating a restructuring is in practice impossible — leaving bondholders in limbo. But optimism that the status could soon be broken has triggered a big rally in its debt.

"The chances of Maduro leaving have now ramped up, in which case the potential for the country to rebound economically and for oil production to come back is going to be much higher," said Anthony Simond, a fund manager at Aberdeen Standard Investments,

which holds Venezuelan debt. "The recovery rates on the defaulted bonds are set to be very large."

The prices of Venezuela's government bonds have jumped from about 25 cents on the dollar earlier this month to more than 35 cents yesterday, while bonds issued by PDVSA, the state oil company, have climbed from roughly 14 cents on the dollar to about 24 cents.

While these still beaten-up prices underscore the risks and the long path that still lies ahead for Venezuela, the

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bounce has helped buoy several big restructuring market bond funds.

Stone Harbor's \$1.2bn Emerging Market Debt Fund, managed by Jim Craig, has gained 5.9 per cent this month, Mike Cornelius's \$6bn T Rowe Price Emerging Markets Bond Fund has returned 5.4 per cent, and BlackRock's \$2.7bn EM bond fund — led by Sergio Trigo Paz — has gained 5.2 per cent.

Emerging bond markets have enjoyed a solid bounce in January, but these

Fixed Income

Greece to tap international debt after deal on Macedonia

KERIN HOPE — ATHENS

Greece plans to tap the international bond market for the first time since emerging last August from its third bailout programme, it was announced yesterday.

The country revealed plans to issue a five-year syndicated bond following a sharp fall in yields on the country's debt. The bullish performance has come after the minority Syriza government ratified a deal to change Macedonia's name, ending a 28-year dispute with its Balkan neighbour.

Yields on the benchmark 10-year bond declined to a four-month low yesterday, trading at 4.07 per cent. The five-year bond was trading at 2.85 per cent, just above a six-month low of 2.83 per cent last week.

"This issue was hanging in the balance last week while the government was scraping up extra votes to push the Macedonia deal through parliament, but the

"The overall climate is more favourable following the positive response to Italy's 10-year issue"

timing now looks good," said one analyst in Athens.

"The overall climate is more favourable among fund managers following the positive response to Italy's 10-year issue last week," added a Greek banker.

Italy sold €10bn of debt — its largest ever deal — this month, with strong order books suggesting investors were willing to look beyond the political ructions that plagued the country in 2018. Analysts said Greece's debt management agency hoped to raise €2.5bn to €3bn from the issue, which is expected to go ahead within the next few days.

The bond offering will also mark Greece's first foray on the international capital markets since emerging from its €86bn third bailout programme last August.

Athens agreed to drop its veto on its neighbour Macedonia's bid to join Nato and begin EU accession talks in return for the country agreeing to rename itself North Macedonia. Alexis Tsipras, the Greek prime minister, said the accord would boost regional stability, adding: "North Macedonia is our friend."



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