Zachary Scott
INVESTMENT BANKERS

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# The Next Big Thing: CLOs

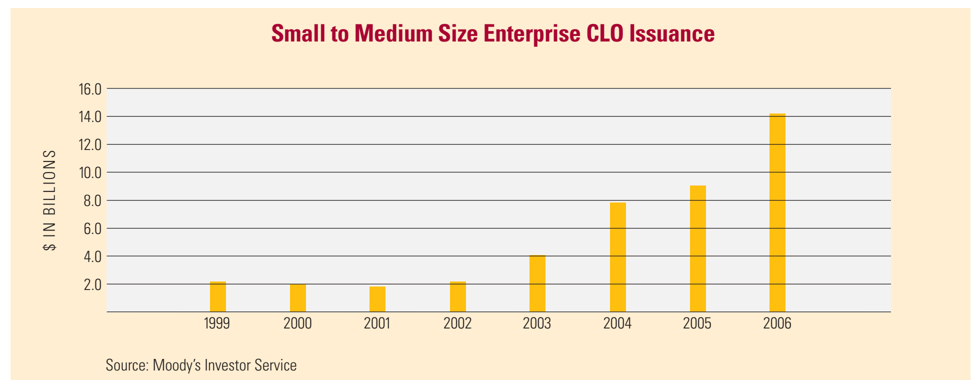
*Collaterlized Loan Obligations (CLOs) will change the nature of lending relationships.*

*by Michael T. Newsome*

The financial intermediation model for commercial lending is changing. Over the next ten years, structured securitized credit, packaged as Collateralized Loan Obligations ("CLOs"), is anticipated to significantly displace the classical commercial lending system that has dominated banking for centuries. This change will meaningfully impact the banking relationships of middle-market and small-business firms.

Historically, banks have attracted capital from depositors and/or investors and channeled those funds to businesses in the form of loans. But, an innovation in asset securitization, known as a CLO, has emerged to effectively reduce both funding costs and regulatory capital requirements, and thereby increase the profitability of lenders originating loans.

Asset securitization, the mechanism of issuing readily tradable securities to investors based upon a pool of illiquid financial assets (mortgages, trade receivables, credit card receivables, etc.) is not particularly new. Robust markets in mortgage- and credit card-backed securities have operated for more than 25 years. However, securitization has rarely found much direct application to the credit needs of middle-market businesses, chiefly because these firms generally do not generate the type and quantity of assets necessary to structure a transaction. Nevertheless, major banks and finance companies have begun to securitize commercial credit (secured and unsecured corporate, middle-market, and small-business loans) in the form of CLOs. Of particular interest are CLOs that focus on loans to small and medium size enterprises (SME). This is a minor, but rapidly growing, segment of the overall asset-securitization market.



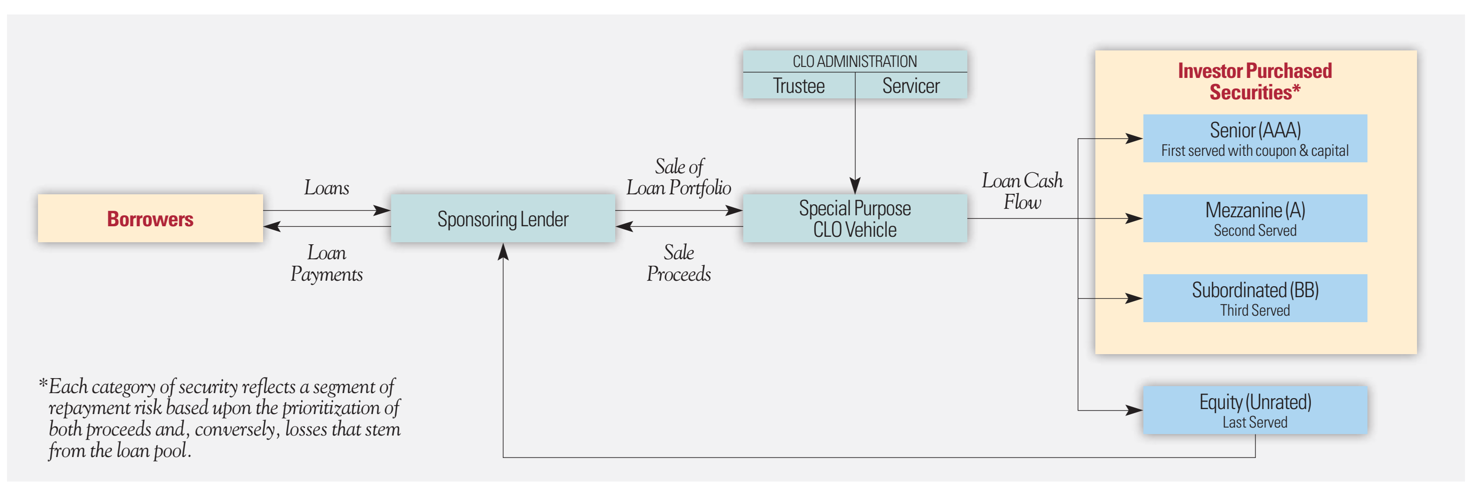

## THE BASICS

In concept, a CLO is a pooling of cash flow-producing, illiquid commercial loans into a stand-alone entity. Rights to the consolidated cash flow from the loan pool are prioritized and split into different buckets or "tranches" of marketable debt securities– senior, mezzanine, subordinated and first loss position (equity)– which are in turn each sold to a specialized group of institutional investors.

Each tranche reflects a segment of repayment risk based upon the prioritization of both proceeds and, conversely, losses that stem from the loan pool. The most junior tranche, the "equity", usually representing 0.5 to 3 percent of the total loan pool, has the last call on CLO cash flow and, thus, the greatest exposure to potential losses. The equity, which is commonly retained by the sponsoring lender, and the subordinated tranche progressively shield the mezzanine and senior tranches from defaults and credit losses. By structuring the allocation of cash flow and risk in this manner, senior and mezzanine securities are accorded high credit ratings from independent rating agencies (Moody's, S&P, or Fitch) and are priced and traded in accordance with their ratings.

## WHY SECURITIZE?

The traditional approach of originating



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## BANK CLO ECONOMICS

| | Pre-Securitization | | | Post-Securitization | | |
|---|---|---|---|---|---|---|
| | $ millions | Libor Spread (bps) | % | $ millions | Libor Spread (bps) | % |
| Loan Assets | 1,000 | 250 | 100.0% | 1,000 | 250 | 100% |
| Liabilities | | | | | | |
| Deposits & Debt | 920 | - | 92% | | | |
| Senior Securities (AAA) | | | | 800 | 33 | 80% |
| Mezzanine (BBB) | | | | 70 | 80 | 7% |
| Subordinate BB | | | | 100 | 400 | 10% |
| Capital / Equity | 80 | | 8% | 30 | | 3% |
| **Total Liabilities / Capital** | 1,000 | - | 100% | 1,000 | 74 | 100% |
| **Net Interest Margin** | 25 | 250 | | 18 | 176 | |
| **Return on Capital before Overhead** | | **31%** | | | **59%** | |

and holding loans on the balance sheet until maturity/repayment creates enduring relationships between a bank and its customers. These relationships are not easily terminated without extinguishing the loans. In a broad sense, securitization is the process of transforming illiquid credit relationships into transactions where securities can be easily marketed to, and traded within, a broad spectrum of investors.

The benefits of CLOs from a lender's perspective are significant. Traditional lending activities are to: (1) originate (find, underwrite and book), (2) fund (hold on its balance sheet), (3) service (collect and apply payments), and (4) monitor (track the borrower's capacity to continue to service) loans. With securitization, these four functions become three—originate, sell and service. This has dramatic implications for the cost structure of a bank. In particular, it reduces the need for highly compensated employees with the analytical skills required to monitor and manage credit relationships.

More importantly, loan securitization lowers overall funding costs. Beginning in 1988 with the Basel Capital Accord, a universally accepted framework was set up for determining the regulatory capital requirements relative to a bank's book of loans. These capital standards motivated the development of loan securitization as a method to transfer the credit risk through the capital markets to third-party investors. In essence, it permits a market-based determination of the appropriate level of capital to backstop a portfolio of loans, rather than a regulatory mandate. By freeing up regulatory capital, the constraints on fresh lending activities are relaxed. The ultimate benefit has been enhanced shareholder value through improved returns on capital (ROC). In a highly competitive market where commercial loan spreads have steadily eroded, it is difficult to justify holding low-yielding loans on the balance sheet against a regulatory capital requirement of as much as eight percent.

As illustrated in the above table, it is more profitable to move a portfolio of non-investment grade loans off balance sheet into a CLO, where the lender retains nearly as much income, with less than half as much capital at risk. As a consequence, major banks and many non-bank lenders are shifting away from using their balance sheets and capital to hold loans,

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and are focusing their efforts on originating, selling, and servicing loans.

It is important to recognize that asset managers, such as hedge funds, have become active buyers of commercial loans. Their objective is to capture the spread, or arbitrage, between the acquisition cost of the assets and the resulting value to investors, when bundled together in a CLO. In part, this explains why more than 70 percent of broadly syndicated loans are now held by non-bank investors.

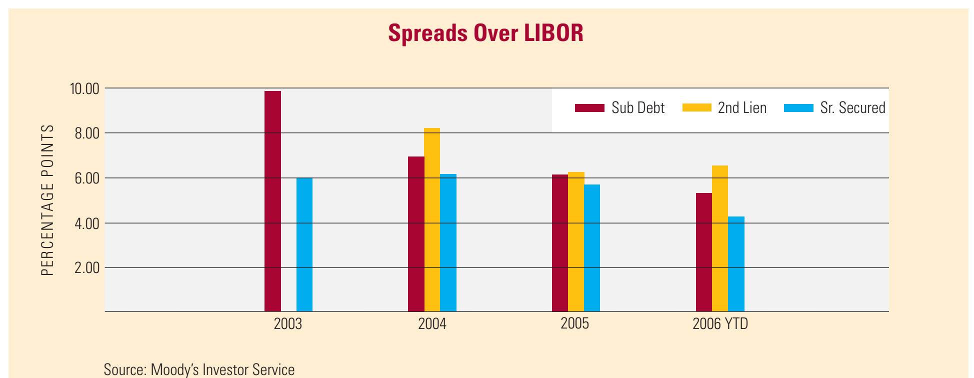
### IMPLICATIONS FOR BORROWERS

Most middle-market companies are unlikely to be aware that their loans may be funneled into a CLO and have little say in the matter. The trend toward commercial loan securitization is evolutionary, so the signs of change are relatively subtle. Major lenders are using CLO funding cost advantages to win origination opportunities. This is reflected in the increasingly aggressive loan pricing offered in competitive situations. Spend a little time talking to regional bankers, and invariably they will express dismay about how cheap credit has become. CLOs are a contributing factor.

Securitization is also a driver behind the proliferation of flexible new credit structures, such as aggressive senior secured, second lien, and subordinated loans. CLOs have become major funding sources for the leveraged lending activities of banks, investment banks and specialty lenders. Demand for these assets, to feed CLOs, exceeds supply. Accordingly, on an absolute basis, senior, second lien, and mezzanine spreads over LIBOR rates are high, but have been declining.

Borrowers have benefited from greater availability of risk capital at terms traditionally not offered by commercial banks. As an example, one major Northwest bank has followed a policy of limiting its leveraged lending to companies with historical EBITDA of $20 million or more. Now, in an effort to expand its market penetration, it has set up a CLO that will be used to fund smaller leveraged lending opportunities for companies with EBITDA between $5 and $20 million. The CLO will enable the bank to aggressively compete in this segment of the market without holding the paper on its balance sheet. This may be a formidable strategy.

From a borrower's perspective, the downside of commercial loan securitization is further weakening of the borrower/lender relationship. Fundamentally, securitization shifts commercial lending away from long-term relationships. The new model is analogous to the public equity market, where the ownership of businesses is securitized into standard financial instruments that are readily tradeable



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and, therefore, highly liquid. A couple of issues arise. First, CLOs require a relatively uniform set of assets. This entails a steady move toward standardization of loan documentation, covenants, pricing indices, tenors, and risk ratings. It is likely that borrowers will pay a premium for customized credit structures in the future.

The more important issue is how loans are handled if the borrower stumbles and defaults, particularly during an economic downturn, when default rates are spiking. There is no historical precedent for this, because the growth in SME CLOs has taken off only in the past few years. In order to protect the credit ratings of the CLO securities, defaulted loans are likely to be removed from the loan pool. The sponsoring lender is unlikely to put the loan back on its balance sheet after its value is impaired, as that would require a protracted workout and incurrence of the regulatory capital hit that it initially sought to avoid. It is more likely that defaulted loans will be sold to distressed debt investors. As discussed in prior *Insight* articles, preservation of value for existing shareholders may be more challenging, when all or a portion of the business' debt is held by investors who are accustomed to pursuing a broader range of alternatives for maximizing the value of their investment. While a bank would usually shy away from taking control of the business, that may be the preferred course of action for distressed-debt investors.

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Overall, the trend toward securitization is a positive one. A broader, deeper market, where investors are more proficient at pricing and managing credit risk, translates into greater availability of low-cost debt capital. As these activities expand and move down market, the way that banks organize themselves and market their products will change. Lenders will increasingly be evaluated based on their skills and efficiency in accessing the market, rather than as capital suppliers and partners with the business. It is not unreasonable to think that, down the road, rather than relationships with lenders, businesses will have relationships with those entities that can best provide access to the capital markets. These may or may not be banks. ❖

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## ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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