PROSPECT NEWS
Market Newsletters for Professionals

Reprint

This article was originally published in the Prospect News Bank Loan Daily and the Prospect News CLO Daily on June 25, 2013.


The Prospect News
Tuesday June 25, 2013
BANK LOAN DAILY
Four Seasons, Herff Jones, Clearwater Seafoods break; Appvion, F+W Media tweak deals
Four Seasons starts trading
Icahn sets talk on $5.2 billion loan for alternative Dell proposal


CLO DAILY
Telos eyes $363.25 million CLO; wider spreads help to slow deal flow; mezzanine notes weak
Telos Asset Management readies for $363.25 million CLO offering

Highland Capital likes loan market, touts CLO as ‘best way’ to play it

By Paul Deckelman

New York, June 24 – Highland Capital Management, LP said the bank loan market “makes sense for investors,” even amid recent Federal Reserve-related volatility, but added that “the best way” for investors to play in loans is by investing in collateralized loan obligations.

Not coincidentally, Dallas-based Highland, with over $18 billion of assets under management, happens to be one of the major players in the CLO industry. It is, in fact, the largest U.S CLO manager by CLO assets under management, with over two-thirds of its total under-management figure in its CLO business segment.

Highland co-founder and chief investment officer Mark Okada declared during the company’s second-half outlook briefing for the financial media on Monday that the CLO market “has been amazing.”

The market, he said, “is open,” despite the impact of scheduled regulatory changes that were to kick in during April and the recent volatility.

He noted that back in December, when Highland put out its projections for the coming year, including an uptick in financial market volatility, it also declared that “securitization made sense in here.”

CLO market performs strongly

According to data compiled by the company, the CLO secondary market returned 30.72% last year – around twice the returns notched by U.S. equities (16%) and high-yield bonds, (14.72%), and over three times that generated by bank loans (9.42%)

At the beginning of the year, Highland was expecting an annual return for this year of between 10% and 14% for CLOs, between 6% and 7% for loans, between 4% and 5% for equities and just 3% to 4% for junk bonds – with lower returns expected in all of the asset classes, but especially in junk because of an anticipated upswing in market volatility

By mid-year, CLO returns were coming in at 12.06% – roughly the mid-point of the expected annual return and virtually neck and neck with equities (12.08%), which were far exceeding initial expectations.

Bank loans (3.18%) were roughly even with high yield (3.14%), although in the extreme market turmoil that followed the Fed’s announcement last Wednesday, while loans retreated modestly, junk got crushed.

Okada noted that while the junk market swooned by some 140 basis points in just one session on Thursday, the day after Fed chief Ben Bernanke’s announcement of the coming cutback in the Fed’s QE3 bond-buying, the loan market was only off by 14 bps that same session, 1/10th the loss suffered by the bonds.

Modifying its original 2013 projections, Highland said on Monday that it still expects loans to come in with a 6% to 7% return on the year. And junk bonds, whose cumulative return at the end of last week was languishing around the 1.5% level, were about half of where they were at mid-year and where they were expected to be for the full year. However, Okada said that if volatility calmed down, junk still might hit the original projection.

Highland upwardly revised its forecast for equities, seeing them finishing between 8% and 12%, about double the original prediction, while CLO debt should rack up between 15% and 20%, living up to the description offered during the briefing by Highland’s head of trading and structured products, Josh Terry, that it’s their “favorite trade.”

Why CLOs make sense

Terry said: “What’s important, given everything that’s going in this environment

Continued on page 2

Reprint

Originally published in the xxx and the Prospect News Bank Loan Daily and the Prospect News CLO Daily on June 25, 2013

Continued from page 1

right now – you have a risk of rising interest rates, you have volatility outstanding – CLOs are an asset class that are floating rate, where spreads over that floating rate are dislocated on a historical basis, and you have a catalyst out there to actually take you out of this dislocated asset class in the near future," when the underlying loans that are bundled together to create the CLO are redeemed.

He said that was one of the reasons behind the "favorite trade" designation "and why we think that it's going to provide returns despite the volatile market that we've seen over the last few weeks."

Terry also pointed out that an investor in a CLO tranche would earn a hefty average spread premium over the yield of the underlying bank loan assets by themselves – spread premiums which ranged anywhere from 12% to 52% in the days before the 2007-2009 financial crisis, compensating the investor for less liquidity and the structural complexity of a CLO. Those spreads shot up to as high as 282% in 2009.

Since the crisis subsided, those spread premiums have backed down to around a still impressive 96%, even though CLOs routinely carry a higher rating than the underlying collateral.

He noted that the same kind of substantial spread premium is also in effect when comparing CLOs to the yields of investment-grade corporate bonds, since, he said, "a lot of people view this product as an alternative to investrment-grade corporates."

Since the credit crisis of several years ago, which brought the then-booming CLO market to a virtual standstill as 2007's record issuance of $104.7 billion of CLO instruments plunged to $20.6 billion in 2008 and dwindled to less than $1 billion by 2009, the new-issue market has rebounded smartly.

Terry said that even with more volatility in the financial markets this year, total CLO issuance is on pace to top last year's $52.7 billion, with $32 billion having been issued through April, "so we see much higher now; we think that $70 billion is still a very reasonable estimate for the end of the year."

CLOs currently account for slightly over 60% of the volume of the new-issue bank loan market.

Terry further noted that CLOs – and their underlying bank debt in general – have historically had very low default rates. Defaults on bank debt reached a peak of 15.4% during the Great Depression and 13.1% during the financial crisis of the late 2000s but currently stand at 2.2%, below the 2.7% historical average.

He said it would take much, much higher default rates than even the peak levels to "break" short-duration CLO tranches so investors would suffer any loss, calling the risk of loss in such tranches as "incredibly low."

Okada said, "Our fundamental outlook for defaults across the bank debt space is low, and it's continuing to be low. We don't have a whole lot of maturities [coming due that would need to be refinanced] and interest coverage is very high."

Some loans trade lower

He did caution that there will be "more idiosyncratic [issuers] that come to the market," setting the stage for a ramp-up in distressed bank-loan paper, not immediately but over the next several years.

He singled out middle-market loan debt – loans made to companies whose annual revenue total between $10 million and $1 billion. Okada said that those companies tend to have considerably more cash-flow problems than their larger competitors because the latter have "more levers to pull."

Okada noted that the problem was particularly acute among health care service companies, whose top lines have been badly affected by a step-up in competitive bidding in the industry over the last several years.

While bank loans have performed considerably better recently than junk bonds in terms of notching smaller losses, Okada said there would continue to be some correlation between the two markets, since "we are in a correlated world."

"Loans are always going to be correlated, more correlated today than they were in past cycles."

Should the current enhanced volatility continue in the high-yield space and in emerging markets, he said, "you'll see loans participating."

That having been said, though, he noted the volatility and the weakness was "much lower than across the other markets, and it makes sense to us. Some of the news stories say the high-yield bond [fund] guys getting [investor requests for] redemptions are selling their loans for it because they were down less. We've been buying some of that stuff; it's the kind of stuff that we pick up."

He said that probably the "big differential" limiting the capacity for loans to follow junk bonds down into a nosedive is the fact that 60% of loans, as noted, are bought by CLOs, with only 20% going to mutual funds and 20% to institutional investors.

"That's not the case with high yield and it's not the case with emerging markets – much more of that money is short-term 'hot money.' If a loan trades to a discount and CLOs are sitting on cash, they love to buy that stuff, so you have a very different buyer

Continued on page 3

PROSPECT NEWS
Market Newsletters for Professionals

Reprint

Originally published in the xxx and the Prospect News Bank Loan Daily and the Prospect News CLO Daily on June 25, 2013

Continued from page 2

base, a much more long-term, consistent buyer base," Okada said.

"It's why we see volatility on the downside for loans being much lower [than bonds] and why we think it's the best place to be."

Loan funds record inflows

This was reflected in recently volatile flows of fresh money into or out of mutual funds or exchange-traded funds specializing in the various asset classes.

While junk bond funds have suffered over $9 billion of outflows over the last several weeks, Okada said this "made sense to us," given the relative unattractiveness of recently issued junk credits with coupons of 5% or less.

Year-to-date inflows to the loan funds have been mounting up in the meantime and now total some $30 billion, which Okada said also "makes a ton of sense to us."

Loans, he said, "are obviously our favorite trader – I think it makes sense that flows are locating into there right now."

He concluded: "For the second half of the year, we still think loans end up a good place to be on a relative basis." ■