



Special Report: Collateral Managers and Takeover Opportunities *Examining CLO Fee Structures*

Summary

AUTHORS:

Guillaume Fillebeen
Director
212.918.4947
guillaume.fillebeen@pf2se.com

Gene Phillips
Director
212.918.4944
gene.phillips@pf2se.com

WEBSITE:
www.pf2se.com

Collateralized debt obligation (CDO) securities remain at this time one of the few fixed-income asset classes yet to benefit from the positive effects of this year's economic rebound.

Indeed, while loan values have enjoyed a significant uptick since year end,¹ collateralized loan obligation (CLO) securities are priced lower across the capital structure despite the fact that these debt securities are primarily supported by pools of loans.

Our goal is to briefly describe why this is the case and then to offer our thoughts on the ramifications thereof, from the viewpoint of collateral manager fee generation and the potential for an alignment of forces within the industry.

- Introduction
- State of the Market
- Collateral Management Fees
- Amalgamation Considerations
- Concluding Remarks

May 26, 2009

¹ Loan prices are up roughly 20% since year-end; by comparison, the Dow Jones Corporate Bond Index is up slightly more than 2% since year-end and more than 15% since its mid-October lows of 2008.

Introduction

As long-term, par value structures, CLO tranche values are perhaps not as highly correlated to the prices of their underlying loans as you may have otherwise imagined.

Improved loan prices, particularly of CCC and below-rated loans, may be helpful to CLOs in their carrying value consideration in the numerator of overcollateralization (“O/C”) tests. One example of this is the CCC/Caa excess amount haircut where, if more than a floor amount (often 7.5%) of the underlying portfolio is rated Caa1/CCC+ or below, the excess collateral over this floor may be “haircut” from its \$100 par consideration for purposes of determining the deal’s O/C coverage.

These dynamics may differ from deal to deal: the floor amount may be 0%, for example; single B-rated or even BB-rated assets may be haircut too; the haircut may be based directly on the collateral’s market value (“MV”) or may be taken as a minimum of the MV and the rating agency-specified haircut for such asset type (e.g., 1st lien loans versus 2nd lien loans), &c.

Given the plethora of rating downgrades resulting from current market conditions, a high percentage of CLOs are exceeding the abovementioned floor level at which they’re able to carry lowly-rated securities at their 100% par value. The MV-based haircut on the excess securities therefore acts to bring down the O/C coverage ratio. Thus, all else equal, higher collateral market values improve (or at least don’t hurt) O/C ratios.

Theoretical example (below): a significant increase in a deal’s CCC-or-below-rated-assets bucket may cause a deal to trip its junior O/C test trigger if the market value of its assets is low (compare Deal 1 to Deal 2). Similarly, a significant uptick in market value may allow a test to pass even though it may have failed in a different market value environment (compare Deal 2 to Deal 3).

Example	Deal Size	% Rated CCC or below	Floor Level	Excess Over Floor	MV of CCC or below Assets	Haircut Amount*		Junior OC Test				
						%	\$	Numerator**	Denominator	Ratio	Trigger	Result
Deal 1	\$500.00	6.50%	7.50%	0.00%	30.00%	0.00%	\$0.00	\$500.00	\$470.00	106.38%	>= 101.5%	Pass
Deal 2	\$500.00	15.00%	7.50%	7.50%	30.00%	5.25%	\$26.25	\$473.75	\$470.00	100.80%	>= 101.5%	Fail
Deal 3	\$500.00	15.00%	7.50%	7.50%	70.00%	2.25%	\$11.25	\$488.75	\$470.00	103.99%	>= 101.5%	Pass

Note: All dollar values are in \$ millions

* Assumes excess CCC or below-rated assets are carried at market value

** Deal size minus haircut amount

State of the Market

Despite the notably improved pricing levels on speculative-grade loans, CLO O/C failures continue unabated: while in January roughly 10% of CLOs were suffering one or more O/C failures,² at the time of writing approximately 55% of deals are tripping at least one O/C test trigger.

In sum, for O/C test calculation purposes, the dual difficulties of continued rating-based downgrades and increasing default rates have thus far together outweighed the twin benefits of higher loan values and the managers’ abilities to build par through discount purchases.

² See for example Preston, Pauley “CLO Market Update: A Cautionary Tale for Treacherous Sailing,” a Wachovia Capital Markets, LLC publication (Jan. 8, 2009) or their insightful “Looking Down the Stack: Examining Single-A Notes” (May 22, 2009).

More generally, CLOs have underperformed the broader credit and leveraged loan markets, with the pricing differential growing between loans and CLO tranches themselves.³ Indeed, despite public expressions of purchasing interest in CLO paper by the likes of Bain’s Sankaty Advisors LLC unit and the reputable Los Angeles-based Ares Management LLC, tranche pricing levels have continued to widen. As a means of comparison, in our February 11, 2009 CLO covenants report we noted that:

“We’re seeing AAA CLOs trading at spread levels of typically 550 to 600 basis points (dollar price levels roughly in the 70s), and AA and below-rated notes trading more regularly on a dollar basis: AAs are mostly trading in the 30s to young 40s, single-As in the mid-teens, with BBBs and BBs in the mid-teens and below.”

Now, AAA CLOs typically trade north of 600 bps over LIBOR and often as much as 8% to 9% over the swap curve. As a dollar price, AAs usually range from the 20s to low 30s, while single As, BBBs and BBs trade in the low teens and single digits.

Collateral Management Fees (“CMFs”)

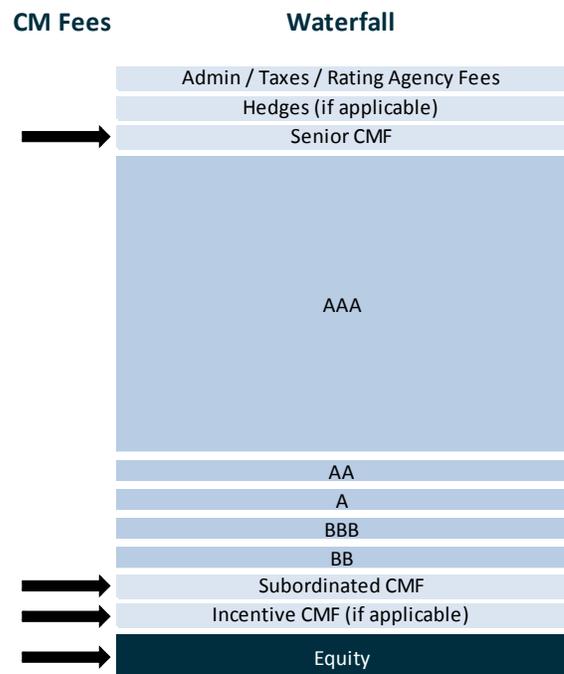
Collateral managers typically earn three types of fees: senior fees, subordinated (or junior) fees and incentive management fees.⁴ (Separately, collateral managers often retain an equity stake in the deals they manage, although this practice, while still common, became less regular in the later vintage CLOs of 2006 and 2007.)

These fees are generated out of the proceeds of the CLO’s underlying assets and are paid according to the deal’s priority of payments. These generated interest and principal proceeds flow top-to-bottom down the structure’s “waterfall.”

As shown in the associated diagram, the manager’s senior fees are truly senior and would survive all but the CDO’s liquidation.

The junior fees, however, are typically subordinated to all of the debt tranches and are, as such, reliant on all tranches receiving their scheduled interest and principal payments and all coverage tests being met, before they are paid.

Thus, while the tripping of an O/C test trigger may for certain CDO noteholders (debatably) prove beneficial, for collateral managers’ deal-driven fees any trips are almost always suboptimal, as they serve to divert⁵ cash flows from any subordinated collateral management



Arrows indicate typical or potential collateral manager exposures

³ While there never was – and was never intended to be – a perfect correlation between the pricing performance of CLO tranches and their supporting loans, this sharp disconnect is more likely technically, rather than fundamentally based: among other things, funding levels for CLO tranches are high if existent; the market for CLO securities continues to be highly illiquid; and there remains a general concern over the quality and availability of primary and secondary loans.

⁴ Incentive fees are usually subject to the equity noteholders having exceeded a certain hurdle, often in the range of a 10% to 14% internal rate of return.

⁵ This diversion may prove temporary (i.e., it is not contractually a permanent “shut off”) but the bears among us will likely argue that absent an Herculean recovery, once shut off, these subordinated will never return.

fees.

We offer the following analysis of annual senior and junior CMFs, based on an analysis spanning 467 CLOs managed by 61 different managers and comprising almost \$250bn in assets under management. As you can tell from the table below, the CLO management fee structure weighs more heavily on subordinated fees, with approximately 40% of fees being generated from senior fees and the remaining 60% from subordinated fees, assuming they have not been shut off. Thus, some collateral managers have already forfeited and others stand to lose as much as 60% of their revenue stream from CDO management, on average.

	CLO Manager Fees as a Percentage of Assets Under Management (in the CLO)							
	Min	10th Percentile	25th Percentile	Median	Average	75th Percentile	90th Percentile	Max
Senior Fees	0.05%	0.15%	0.17%	0.20%	0.19%	0.20%	0.20%	0.38%
Junior Fees	0.10%	0.25%	0.30%	0.30%	0.32%	0.36%	0.41%	0.63%
Total Fees	0.20%	0.43%	0.50%	0.50%	0.51%	0.53%	0.61%	1.00%
Portion of Fees that are Junior	33.33%	57.62%	60.00%	60.12%	62.05%	66.86%	72.81%	84.62%
Deal Size (mm)		\$364.24	\$439.00	\$518.06	\$532.15	\$602.64	\$673.32	

In hedge fund terminology the above (median scenario) can be thought of as 20bps upfront annually followed by an additional 30bps annually if all debt and coverage ratio requirements are met. These in turn will be followed by potential incentive fees if the equity (residual) noteholders achieve a certain IRR hurdle, which is seldom the case. In sum, it's not quite "2 & 20," but rather "0.2 and possibly 0.3 & 20" with a proportionately low level of investor redemption capability.

Amalgamation Considerations

Manager consolidation activity, while noticeable, at best remains slow⁶ for at least two reasons:

- various logistical hurdles (not to mention key man clauses in deal indentures) need to be overcome in transferring collateral and/or managerial responsibilities from one institution to another; and
- the adverse economic environment may discourage a struggling manager from selling into a heavily buyer-friendly market, preferring to eke out a living, slim resources where possible, and hope for a turnaround.

Conversely, some of the larger entities may seek to benefit from these economies of scale, as they already have the infrastructure and capacity in place to absorb additional collateral management responsibilities, and grow their assets under management.

The key questions then are for how long certain managers will continue to receive any subordinated management fees – that is, for how long their O/C test triggers will continue to be satisfied -- and whether existing operations are sustainable by senior fees alone.

⁶ Less than a week ago, for example, Avenue Capital Group decided against selling its high yield loan unit, where it manages CLOs.

Example: A Tale of Two CDOs

Deal Name	Closing Date	Manager	Original Deal Size (mm)	Current Deal Size (mm)	Senior CMF	Junior CMF	Junior O/C Test	Original CMF Generation		Current CMF Generation	
								Base	Junior	Base	Junior
Gale Force 2 CLO, Ltd.	06/22/06	GSO Capital	\$483.08	\$498.97	0.25%	0.40%	Passing	\$1.25	\$2.00	\$1.26	\$2.02
Belhurst CLO, Ltd.	03/07/06	INVESCO	\$483.99	\$487.62	0.20%	0.30%	Failing	\$0.96	\$1.44	\$0.96	\$0.00

Notes:

Collateral Management Fees (CMFs) are annualized as a percentage of assets under management (i.e., "deal size")

All numbers are estimates based on data pertaining to April 15, 2009 payment reports

The bargaining considerations, therefore, are expected future fee generation and how many years of revenues the bidder – or successor manager – is willing to offer, taking reputational risk (and goodwill, for that matter) into account. Primus Guaranty’s May 12 purchase of Boston-based loan manager CypressTree Investment Management LLP is noteworthy for this reason: in addition to adding loan management expertise and being able to hand over their CLO management to the joining CypressTree investment managers, Primus may hope to benefit from an increased ability to raise capital on the back of their improved resources.

But aside from the odd purchase, the focus remains on business operation sustainability. As FitchRatings noted in its April 24 Global Special Report:⁷

“...CDO asset manager replacement has [thus far] been [limited] to one of four circumstances:

- the outgoing manager has exited the business and/or ceased operations altogether;
- the outgoing manager has failed specific performance covenants built into the CDO indenture or collateral management agreement;
- the departure of key senior personnel;
- the majority CDO investor has sought to consolidate its exposure to CDO asset managers.”

Concluding Remarks

As we contemplate future buyout activity, it seems logical to separate the CLO collateral managers into at least three distinct groups:

1. the relative new (late 2004-2007) CLO managers (e.g., HillMark Capital Management, New Amsterdam Capital) who have two to four CLOs under management and limited resources;
2. the more established, but primarily pure CDO managers with five or more deals under management (e.g., Kingsland Capital Management, Callidus Capital Management); and
3. the multi-asset managers (e.g., TCW, Credit Suisse Asset Management) who have various channels and funding sources and capabilities at their disposal, and whose CDO unit is merely a platform among many operations, rather than a sole line of business.

We fear that absent a continued, significant loan-level rally, the “newer” managers may need to seek the assistance of a stronger hand, while the established, pure CLO managers may or may not survive based on their performance and reputation. The better-positioned multi-asset managers may be motivated to grow their asset and investor base during this period, taking advantage of the lucrative opportunities that exist for the liquid, and the strong.

⁷ Thomas, Fink-Stone et al. “CDO Asset Manager Replacement Activity Update”

RELATED RESEARCH

February 11, 2009: [Special Report: The Corporate Loan & CLO Conundrum – Investigating their Covenants](#)

January 27, 2009: [Special Report: 2008 – A Troubling Year for TruPS CDOs](#)

Disclaimer

This research report is for information purposes only and should not be construed to constitute a solicitation, recommendation or offer to buy or sell these securities or financial instruments in any jurisdiction, or an official confirmation of any transaction, or as an official statement of PF2 Securities Evaluations, Inc. (PF2). Information contained herein may be obtained by PF2 from sources believed by it to be accurate and reliable. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein. PF2 does not undertake that investors will obtain profits, nor will it share with investors any investment profits nor accept any liability for any investment losses. Investments involve risks and investors should exercise prudence in making their investment decisions. Please be advised that any discussion of U.S. tax matters contained within this presentation is not intended or written to be used and cannot be used for the purpose of (i) avoiding U.S. tax related penalties or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. PF2 does not provide accounting, tax or legal advice. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND MAY NOT BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, TRANSFERRED, REDISTRIBUTED OR RESOLD FOR ANY PURPOSE, IN ANY SHAPE OR FORM, WITHOUT PF2'S PRIOR WRITTEN CONSENT.