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FitchRatings

CLOs in the Heartland

April 26, 2016

Opening Remarks

Jill Zelter, Managing Director, Fitch Ratings

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State of the Capital Markets:

First Quarter 2016 Review and Second Quarter 2016 Outlook

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April 26, 2016

Churchill
Asset Management
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Capital Markets Review – First Quarter 2016

Volatility eases as market conditions stabilize

- US public markets recovered from 4Q lows; dovish Fed eases investor worries about inflation; China, commodities, and energy take back seat
- HY issuance has modest comeback as fund flows reverse; bond volume at $35.5B, flat to last quarter, but off sharply from $91.6B for 1Q 2015
- $41B of US leveraged loans was 18.6% off previous quarter ($50.4B) – worst quarterly performance since 2011; retail loan funds broke a 32-week streak of outflows in March; YTD still negative at $4.9B
- Middle market sponsored volume of $6B (est.) is lowest in six years
- Risk retention worries and below-hurdle equity returns grind new CLO formation to near-standstill of $7.1B (vs $25.3 for 1Q 2015)

Sources: S&P Capital IQ, Thomson Reuters LPC

Capital Markets Review – First Quarter 2016

What's the setting for debt and equity INVESTORS?

- Low-rate, low-growth environment remains challenging for PE returns; purchase price multiples close to record highs
- 1Q saw advantage swing to the buy-side as spreads remained wide
- Private credit funds continue to fundraise and invest; regulated banks retreat from highly leveraged transactions
- Chase for yield winning out over liquidity or credit concerns; institutional investors have swung back to higher risk alternatives
- With BDCs cash-constrained, second lien has been disintermediated by mezzanine; unitranche and senior stretch taking larger structure shares

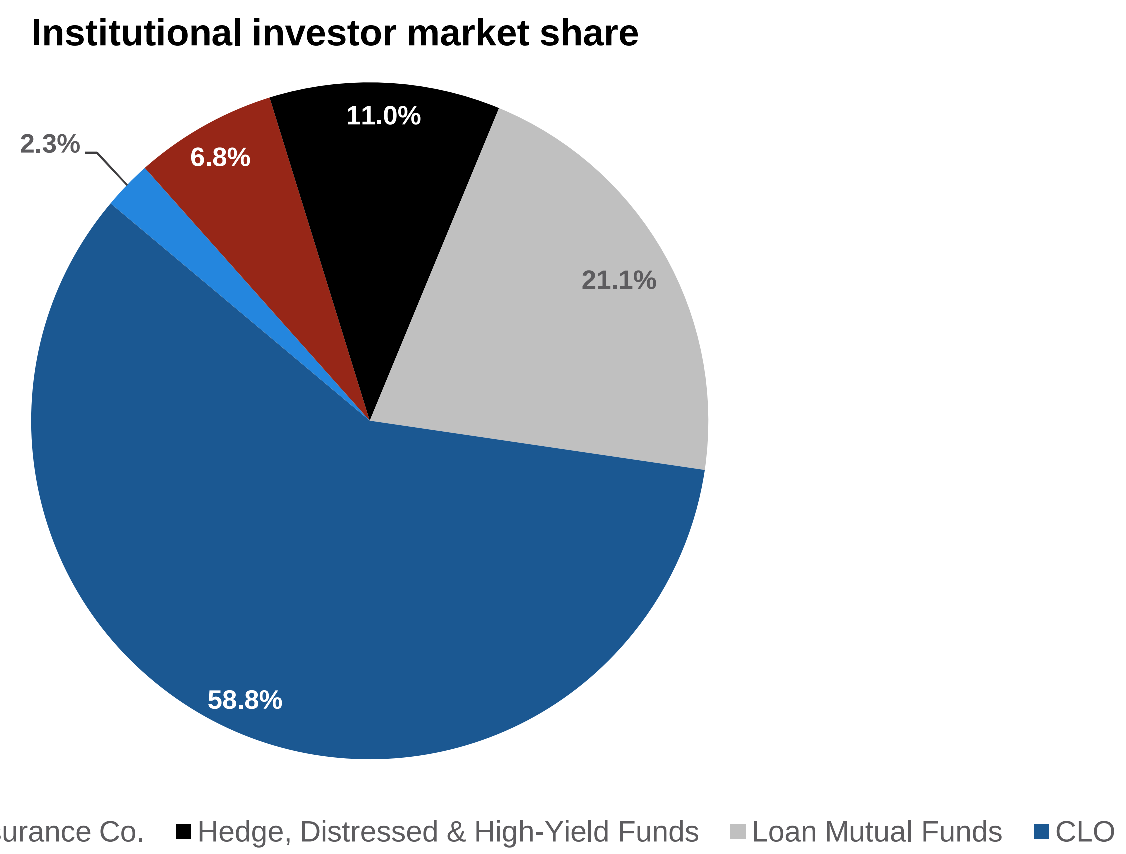
Capital Markets Review – First Quarter 2016

How about debt and equity ISSUERS?

- Known large cap borrowers getting good terms in broadly syndicated market; story credits still struggling amid constrained market liquidity
- Larger middle market arrangers with higher holds offering “club execution” alternative to syndication for increasingly bigger deals (“cargo pants” strategy”)
- Sponsors getting one-stop shop solutions from private credit providers; unitranche financings providing certainty of execution
- Borrowers and sponsors seeking flexibility at a price; covenants, debt baskets, and structures all continue to be issuer-friendly

Capital Markets – Behind the Scenes

CLOs remain a significant share of the institutional market

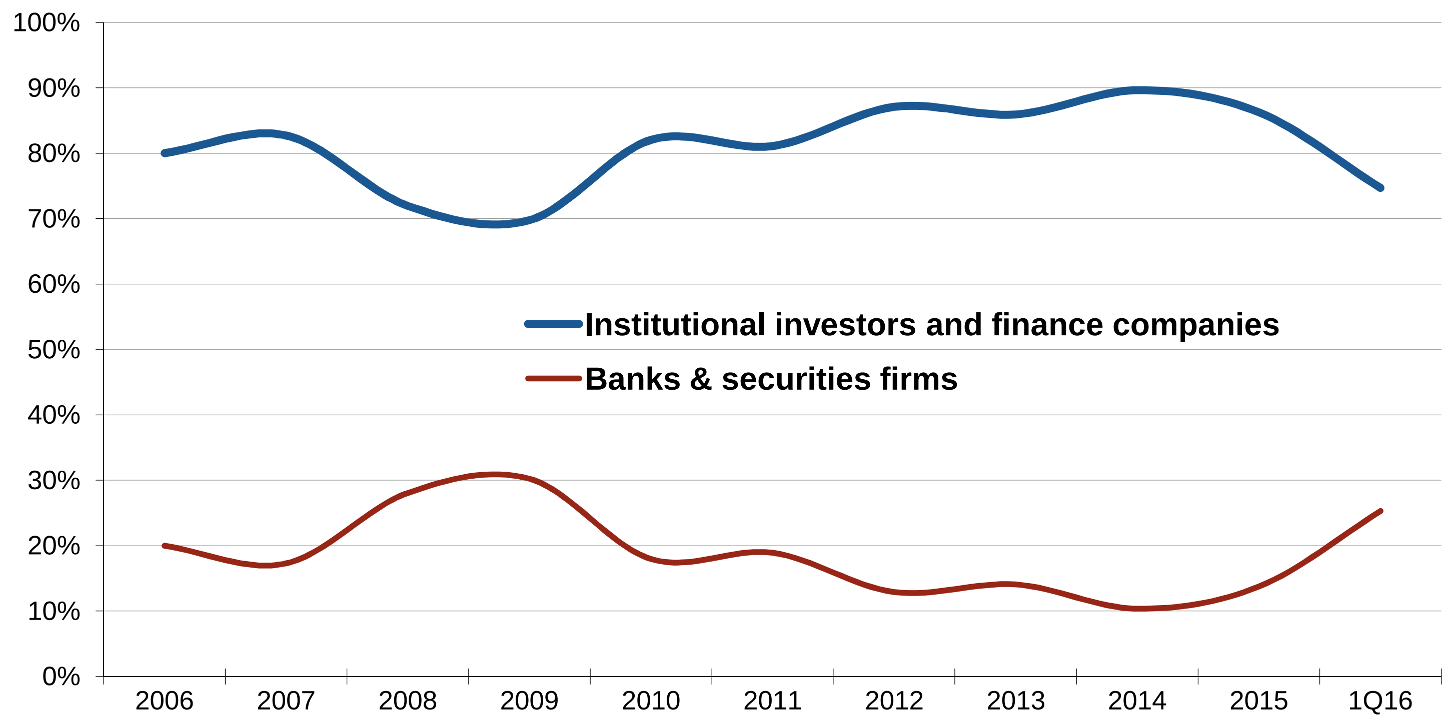


Institutional investor market share **Source:** S&P LCD, Capital IQ

Capital Markets – Behind the Scenes

With deal flow down, banks' share of loans has rebounded

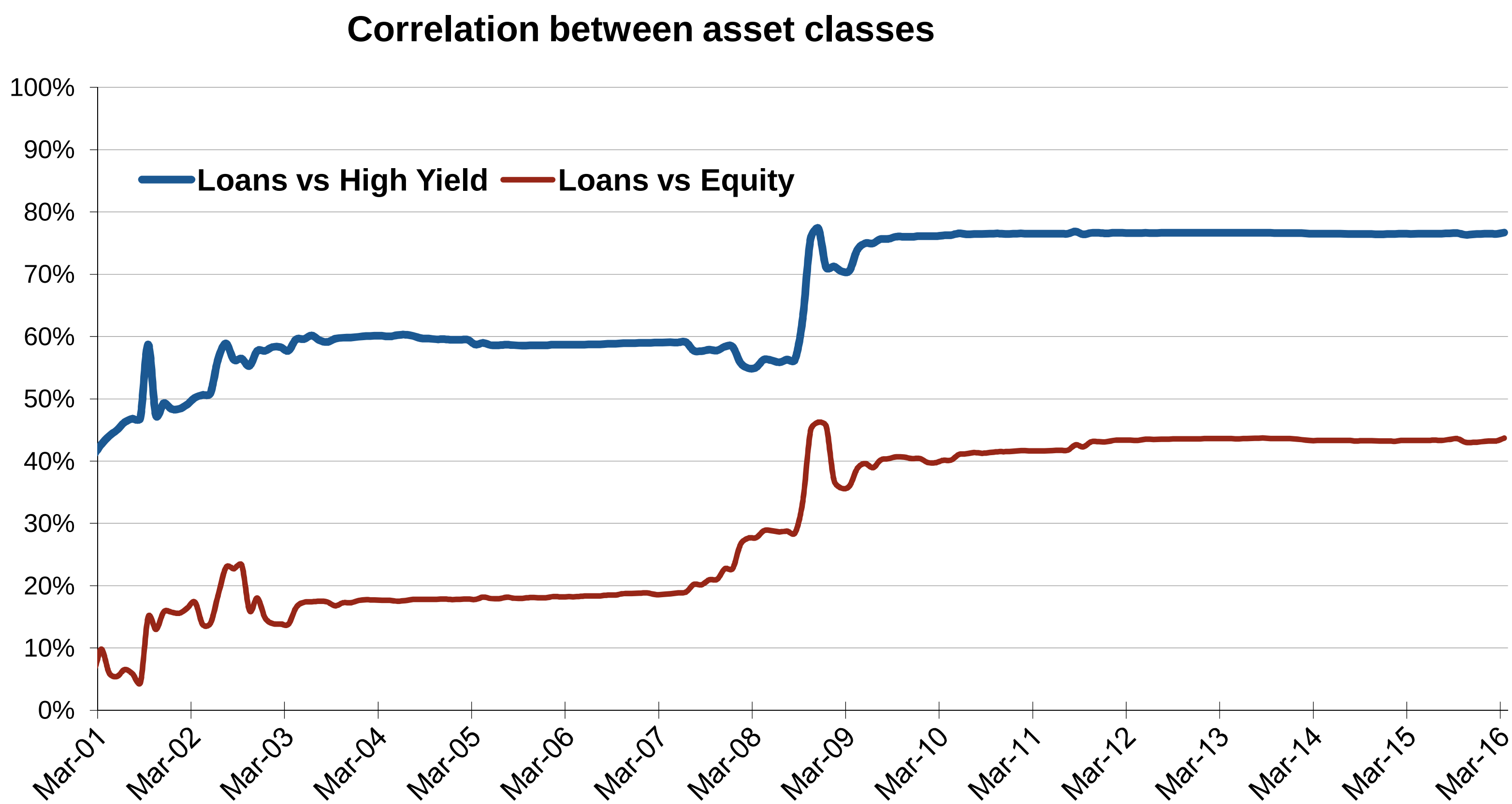
Primary market for highly leveraged loans (banks vs. non-banks)



Institutional investor market share **Source:** Wells Fargo, S&P LCD Capital IQ

Capital Markets – Behind the Scenes

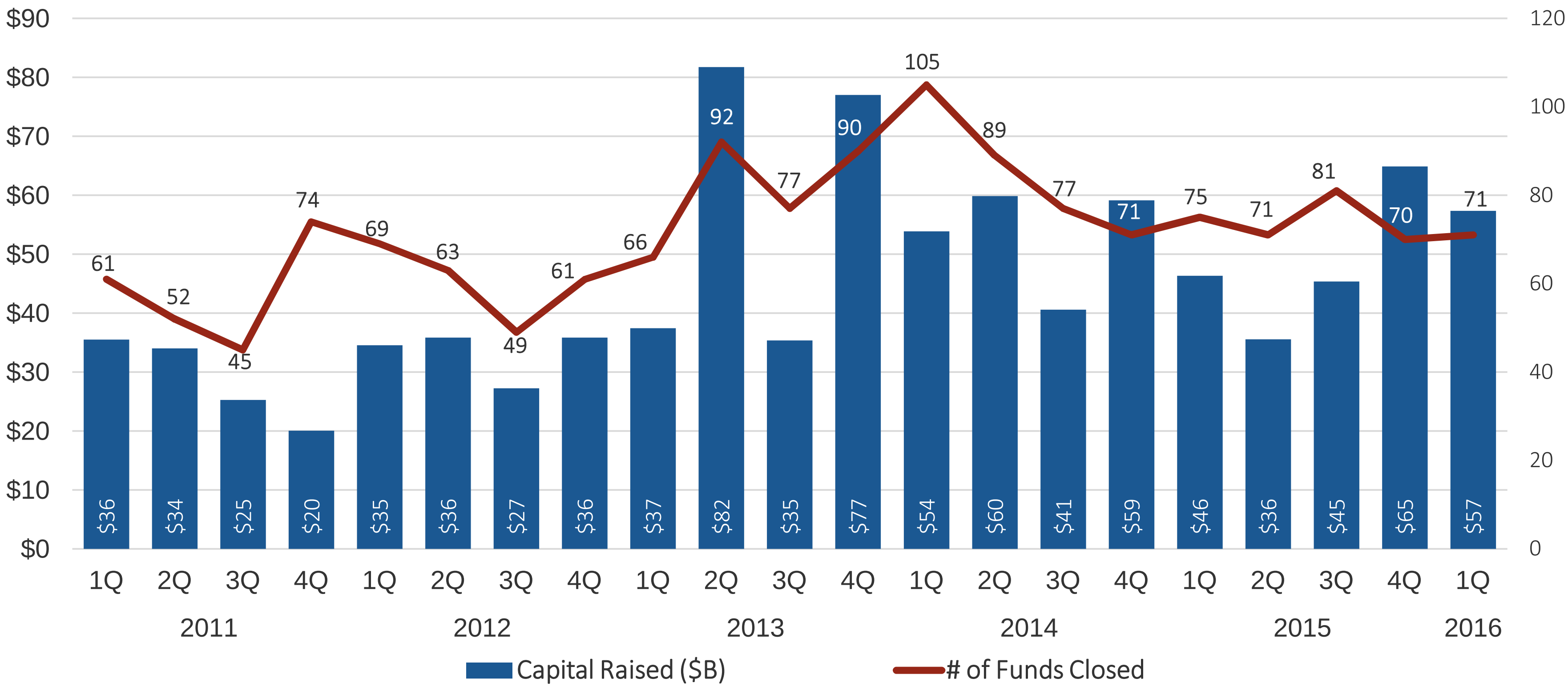
Correlation between asset classes has grown since the credit crisis



Shows cumulative correlation between indicated asset classes **Source:** LSTA, S&P LCD

Capital Markets – Behind the Scenes

PE fundraising remains healthy, as expected…



Source: PitchBook; data for North America

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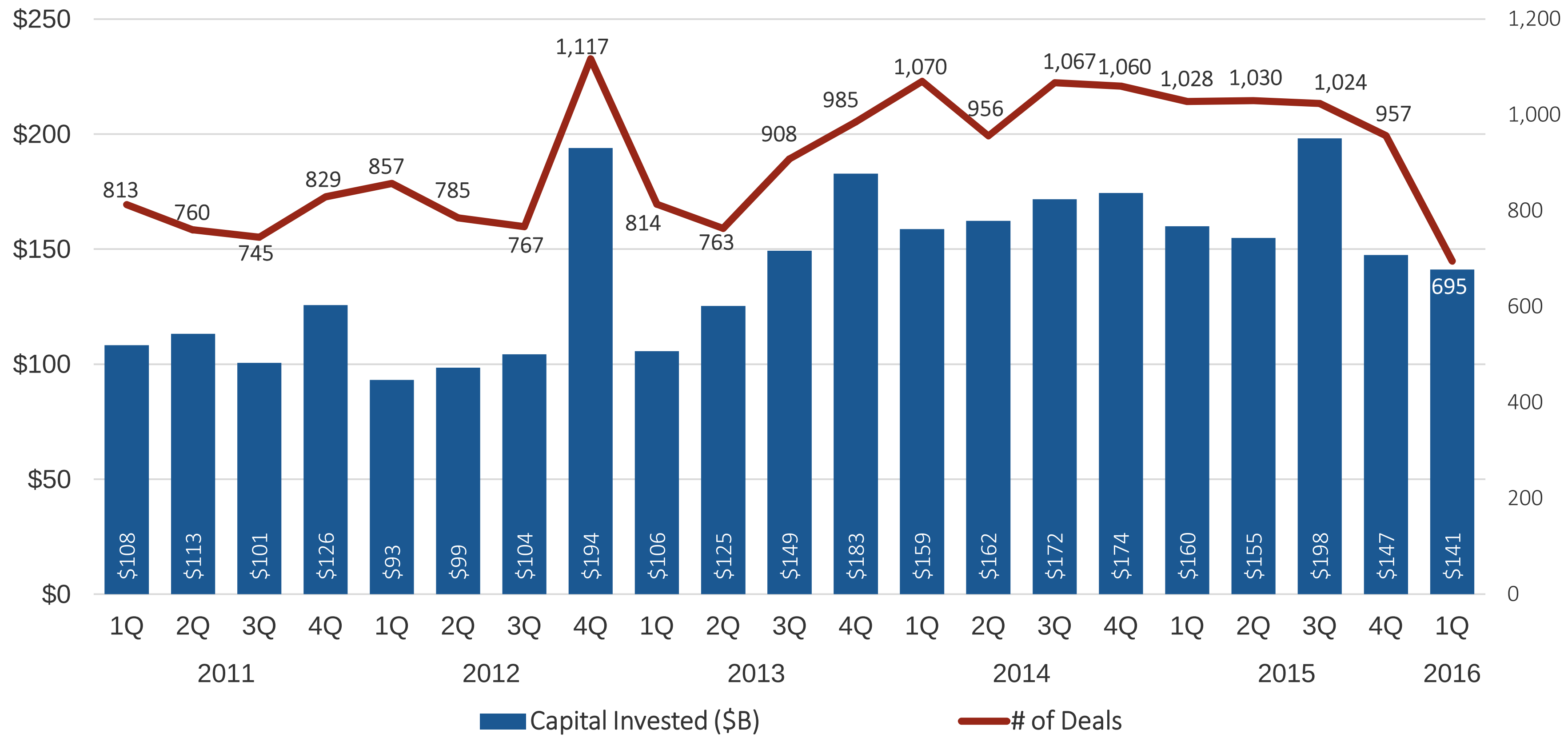
Capital Markets – Behind the Scenes

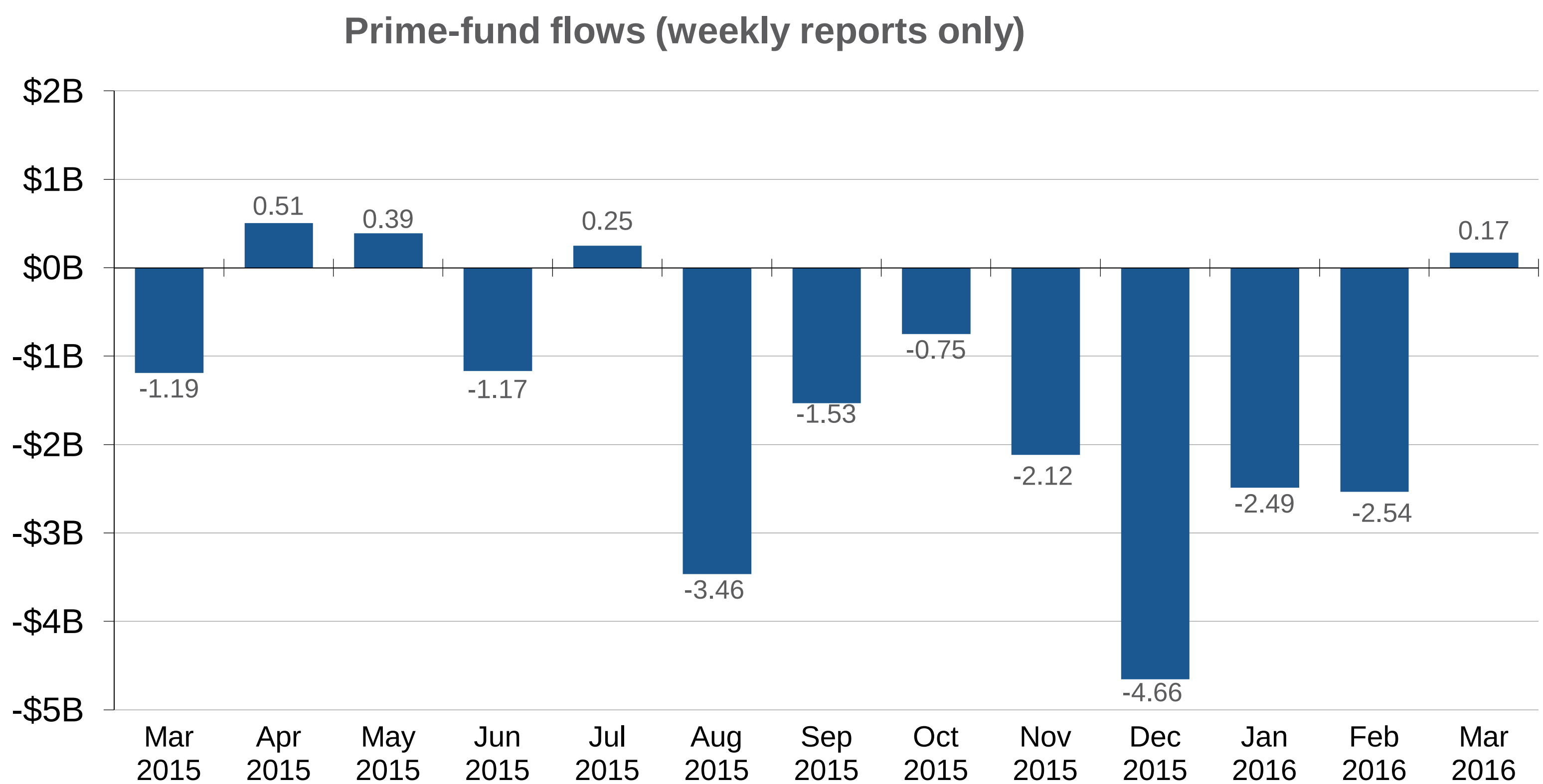
…while deal flow declines for third consecutive quarter



Source: PitchBook; data for North America

Capital Markets – Behind the Scenes

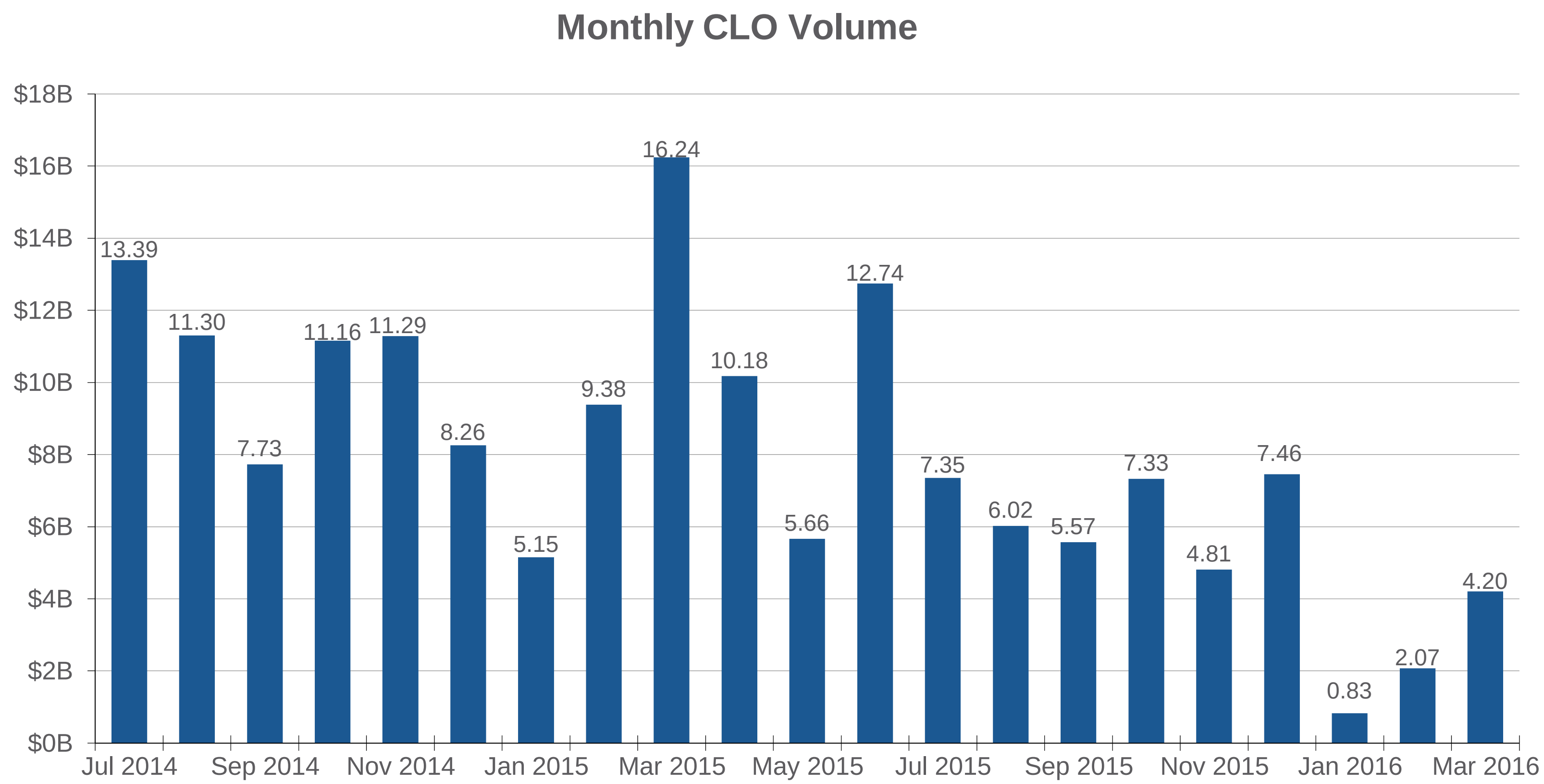
Sense of market stability causes investors to reverse out-flows



Source: S&P/LCD

Capital Markets – Behind the Scenes

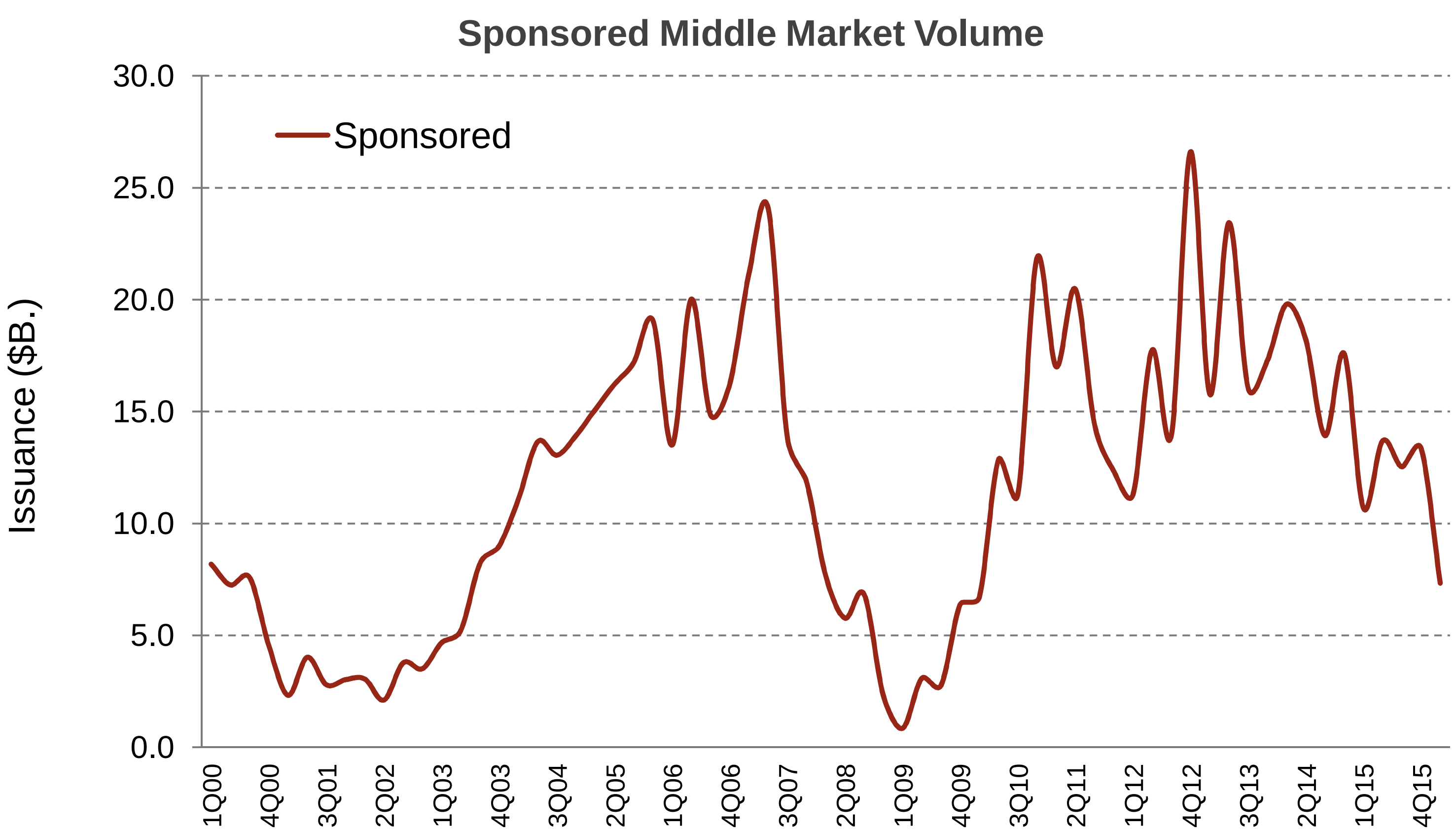
New CLO formation building slowly; lowest volume in four years



Source: S&P/LCD

Capital Markets – Behind the Scenes

Financing activity with sponsors slumps amid uncertainty



Source: Thomson Reuters LPC

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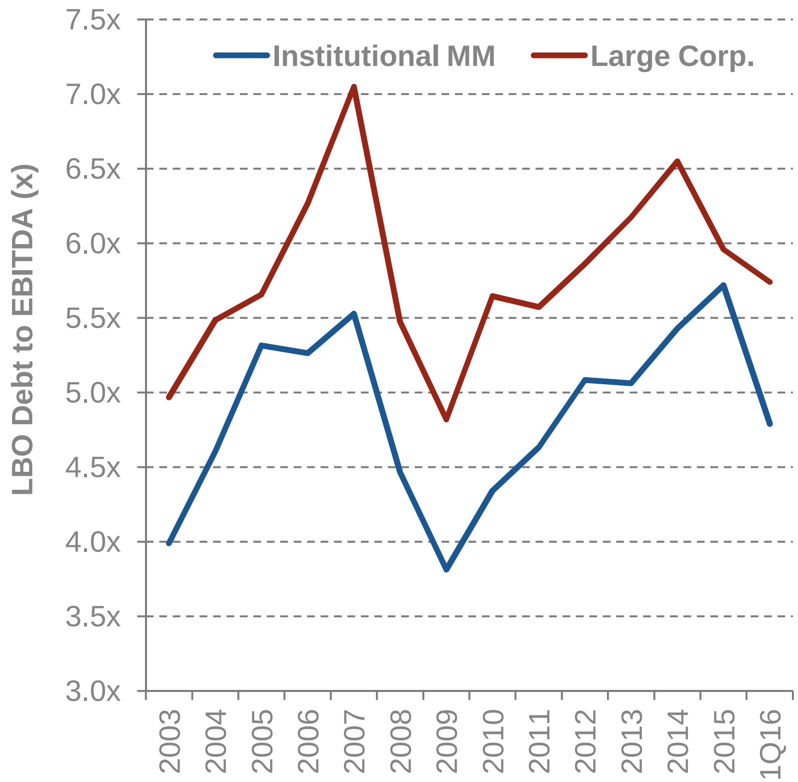
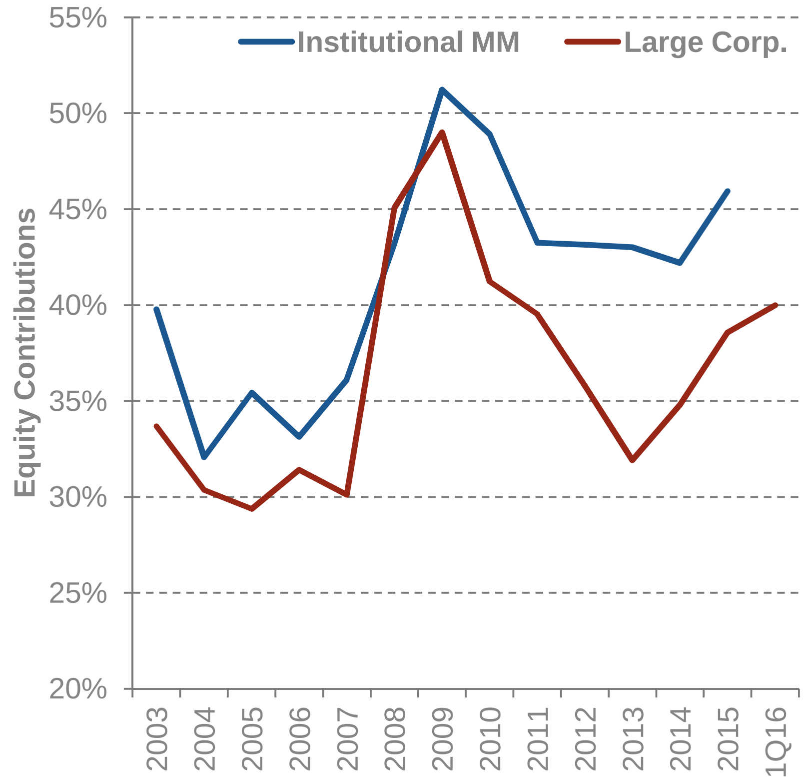
Capital Markets – Behind the Scenes

LBO leverage is down, thanks to Leveraged Lending Guidance





Source: Thomson Reuters LPC

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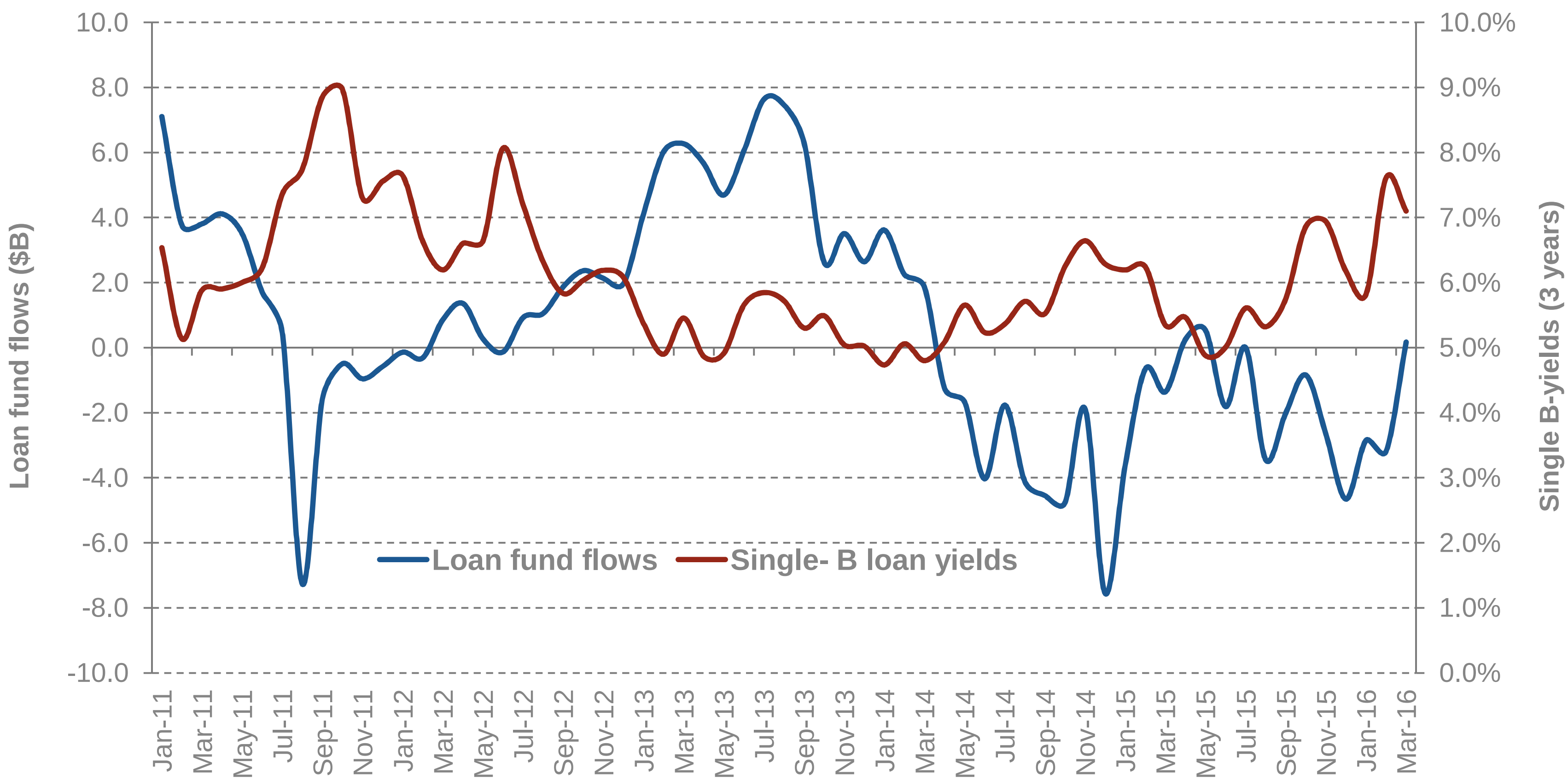
Capital Markets – Behind the Scenes

Supply/demand dynamics continue favoring investors

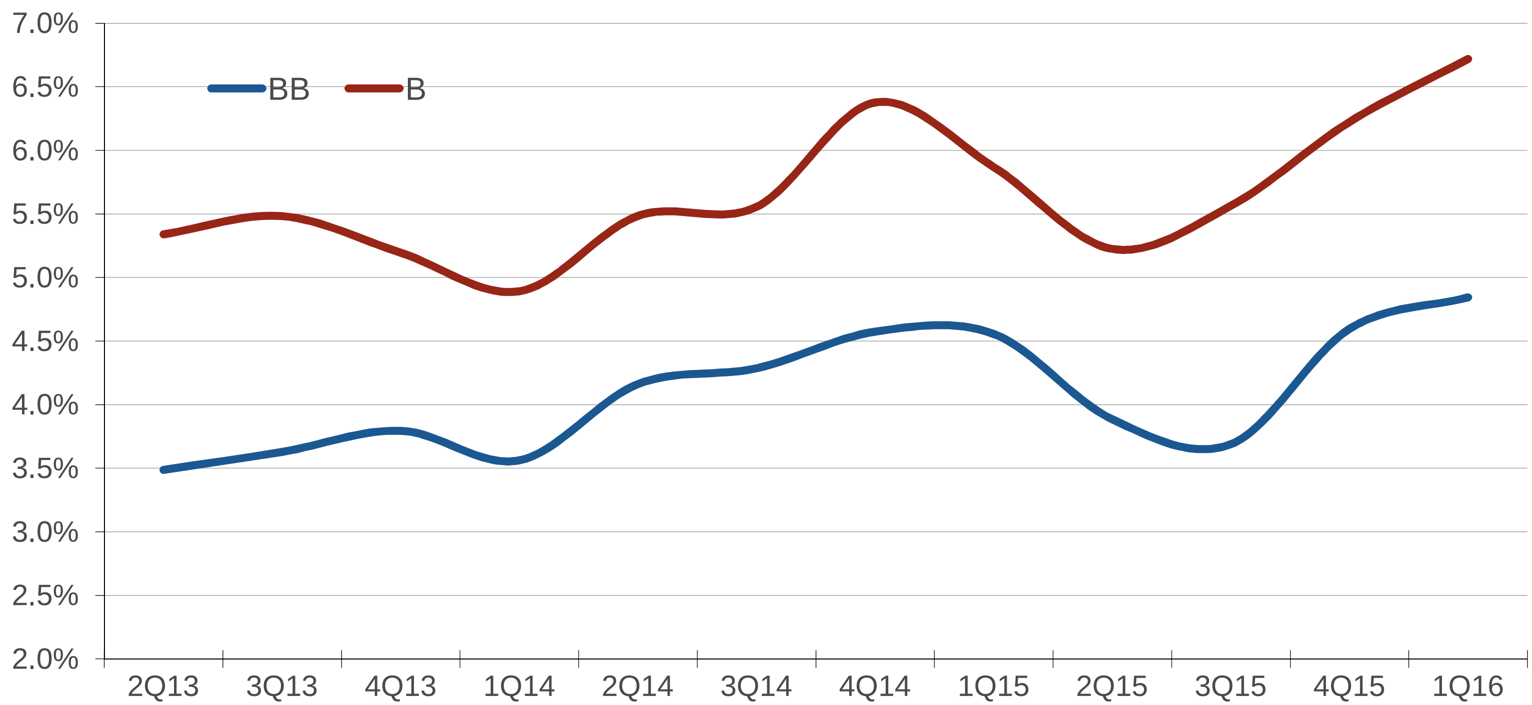


Source: Thomson Reuters LPC

Capital Markets – Behind the Scenes

Better credits get better pricing; liquidity challenged regardless

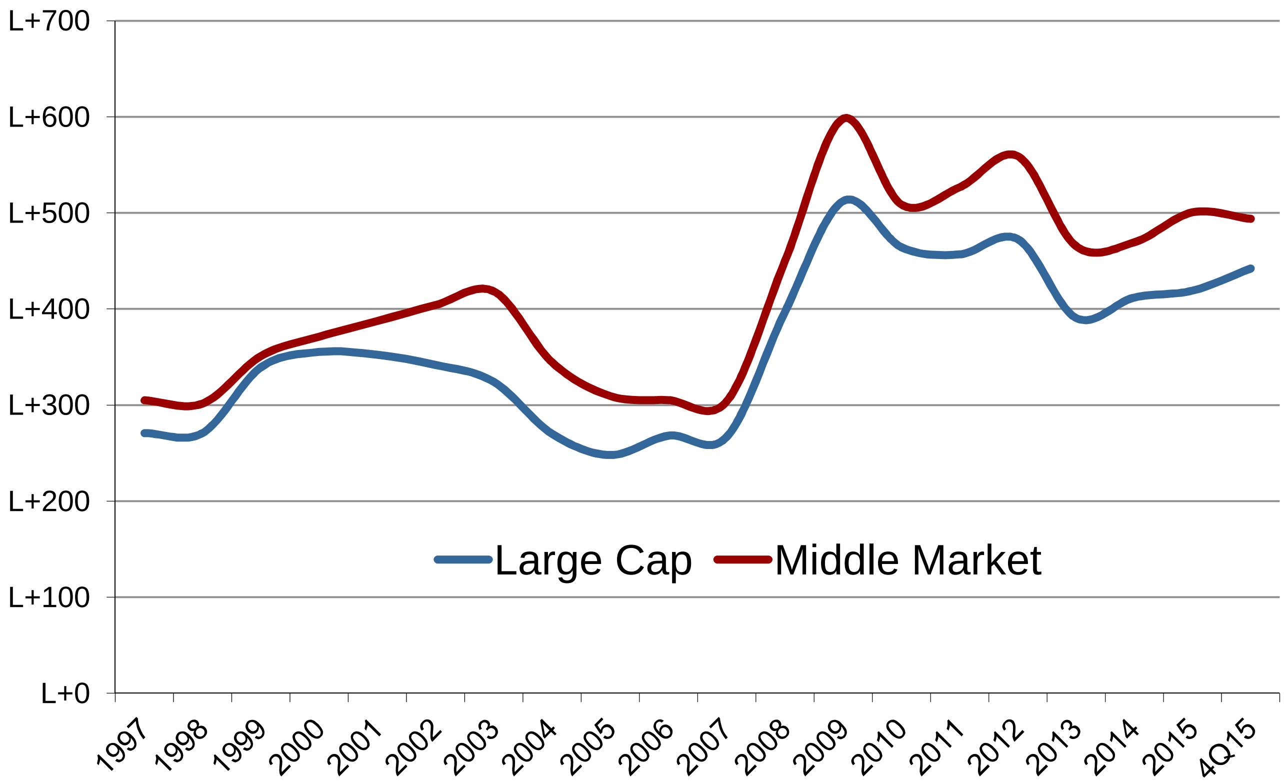
New-issue yield to maturity for leveraged loans



Source: S&P LCD

Capital Markets – Behind the Scenes

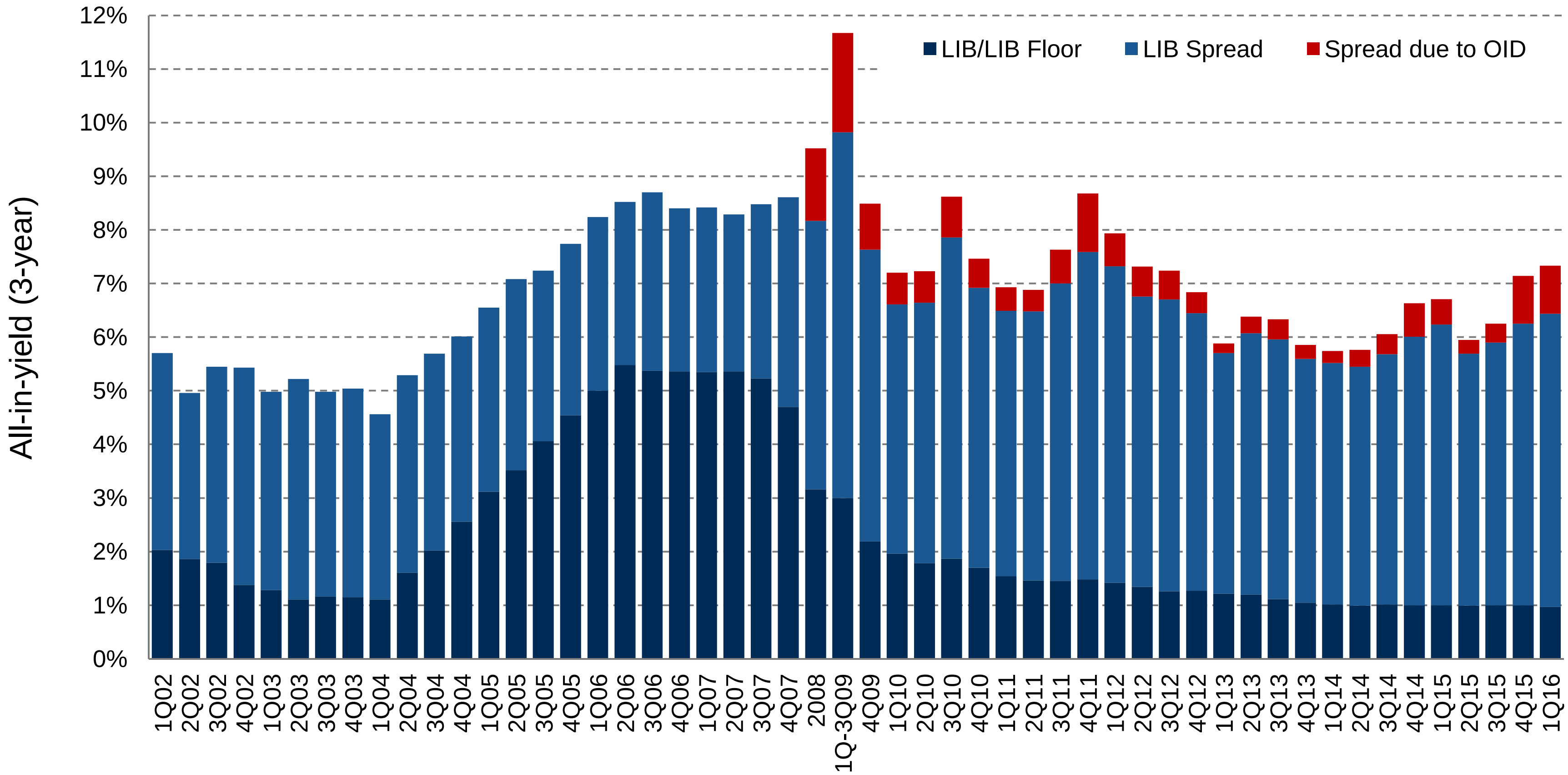
Middle market illiquidity premium remains around 75 bps



Source: S&P LCD; institutional spreads, sponsored transactions; LC = >$50mm ebitda, MM = <$50mm ebitda

Capital Markets – Behind the Scenes

Middle market leveraged loan yields up fourth straight quarter

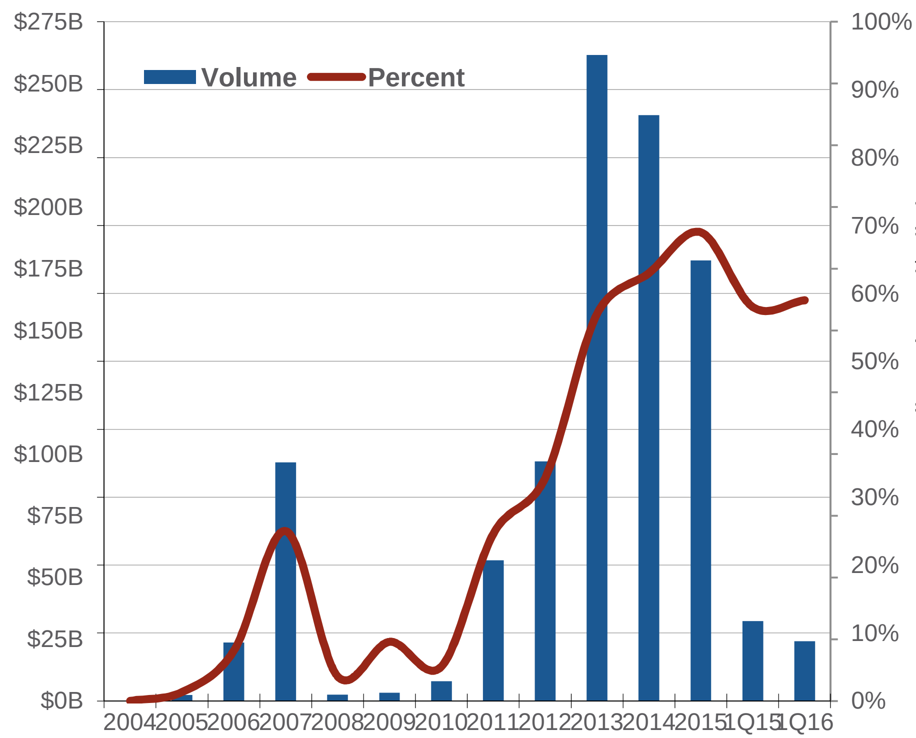


Source: Thomson Reuters LPC; all-in middle market institutional yields (3 year)

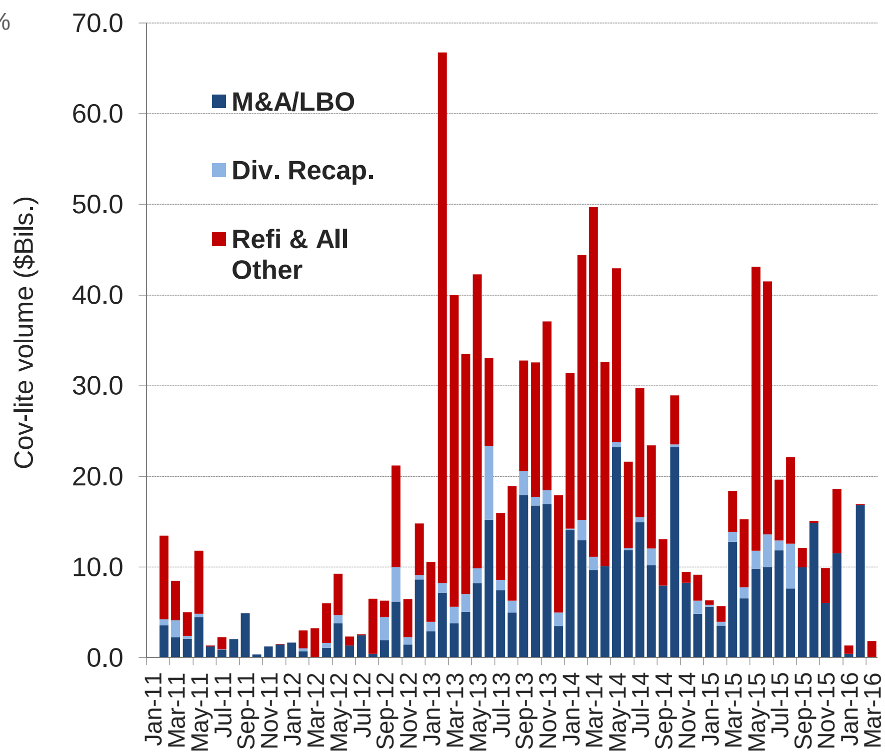
Capital Markets – Behind the Scenes

Structural terms remain seller-friendly, despite lower volume

US Covenant-Lite Loans



US Covenant-Lite Loans (by purpose)



Source: S&P LCD & Thomson Reuters LPC

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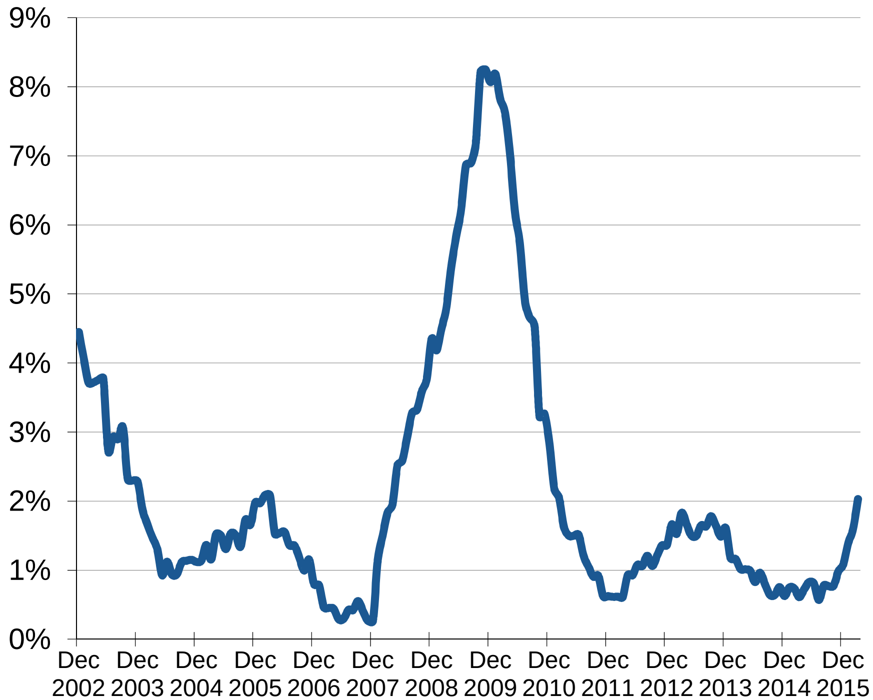
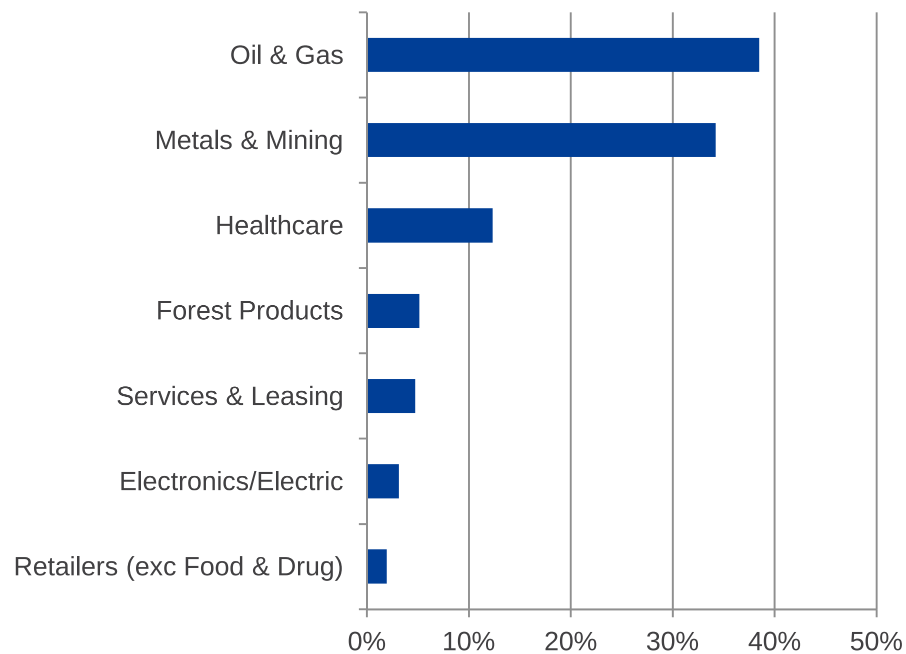
Capital Markets – Behind the Scenes

Energy and commodities push default rate to five-year high

Lagging 12-mo leveraged loan default rate by number



Composition of defaults (LTM thru March 2016)



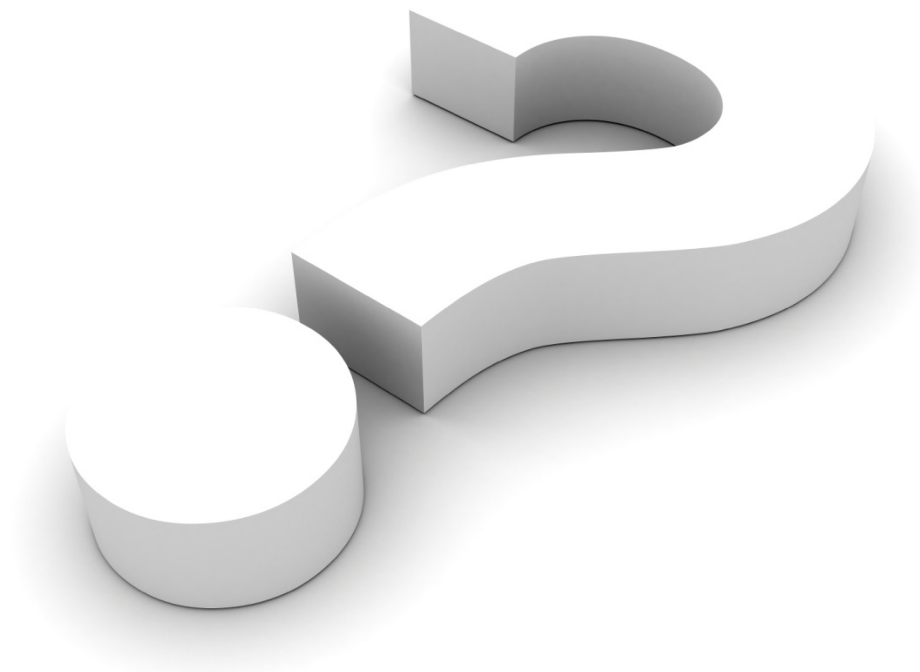
Source: S&P LCD

Capital Markets – Second Quarter 2016 Outlook

Supply/demand balance creating "Goldilocks" effect

- Deal flow will pick up modestly as sponsors work to put "dry powder" to work
- Technicals in broadly syndicated market will continue to favor investors, though needle likely to swing further sell-side later in second quarter
- Middle market conditions will be constructive for both issuers and investors; increased direct lender demand balanced by weak CLO and bank appetite
- Unitranche remains hot product; more direct lending capacity coming from new firms; smaller managers merging or bulking up with JV's and partnerships
- All-in first-lien loan yields ease to <6% for BSL's; mid caps remain in 6-7% range
- Senior leverage of 3.5-4x; total of 5-5.5x for traditional middle market; 4.0-4.5x senior/5.5-6.0x total for larger mid caps; >4.5x senior/6.0x total for BSL

QUESTIONS



State of Middle Market Lending and BDCs

State of Middle Market Lending and BDCs

Moderator:

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April 26, 2016

Volcker Rule – Legacy CLOs

- The Volcker rule prohibits banking entities from making or maintaining investments in “covered funds”
- CLOs are generally covered funds since they rely on Section 3(c)(7) for an exemption from the Investment Company Act
- Since the adoption of the Volcker rule, the CLO market generally has been using the “loan securitization” exclusion under the Volcker rule and has been “Volckerizing” many legacy CLOs to become eligible therefor

Volcker Rule – Legacy CLOs (Con't)

- However, some legacy CLOs have not yet been "Volckerized" and prior expectations that they would have been refinanced are being challenged by current market conditions
- Acknowledging that banks have been important investors in CLOs, the Federal Reserve Board (FRB) has extended the conformance period for banks that invest in CLOs until July 2016 and stated that the FRB intended, if banks were making good faith efforts for conformance, to grant one additional extension until July 2017 and that they would do so in 2015. So far, the FRB has not extended such conformance period

Quick Risk Retention Primer

- Compliance already required for all new RMBS deals; compliance for all other deals beginning December 24, 2016
- Sponsor of a securitization transaction generally must retain at least 5% of fair value as of the closing date of all "ABS Interests" in the transaction
- Forms of Risk Retention:
  - Eligible vertical interest
    - Can be either:
      - A single vertical security or
      - An interest in each class of ABS Interests issued as part of the securitization transaction
  - Eligible horizontal residual interest (or reserve account) or
  - Any combination of the above
  - Special rules for specific types of deals

Credit Risk Retention for CLOs

- For CLOs
  - Collateral Manager is “sponsor” and required to retain
  - Lead Arranger exemption is not practical
  - Issue is therefore how to optimally capitalize retention
  - 4 possible basic approaches:
    - Direct Capitalization
    - Capitalized Manager Vehicle (CMV)
    - Majority-Owned Affiliate (MOA)
    - Capitalized-MOA (C-MOA)

CLO Industry Reactions

- Why us?
  - Not originate-to-distribute
  - CLO manager acts as agent for CLO
  - Collateral acquired in secondary transactions
- Regulators confused and over-reached
  - LSTA sued in November 2014 in DC Court of Appeals claiming that:
    - CLO managers are not "securitizers" and cannot be subjected to risk retention
    - The federal agencies misconstrued the meaning of "credit risk" by requiring a horizontal equity slice equal to 5% of the fair value
    - The federal agencies acted arbitrarily by failing to consider less costly alternatives proposed by commenters
  - Hearing on February 5 (audio: https://www.cadc.uscourts.gov/recordings/recordings.nsf/)

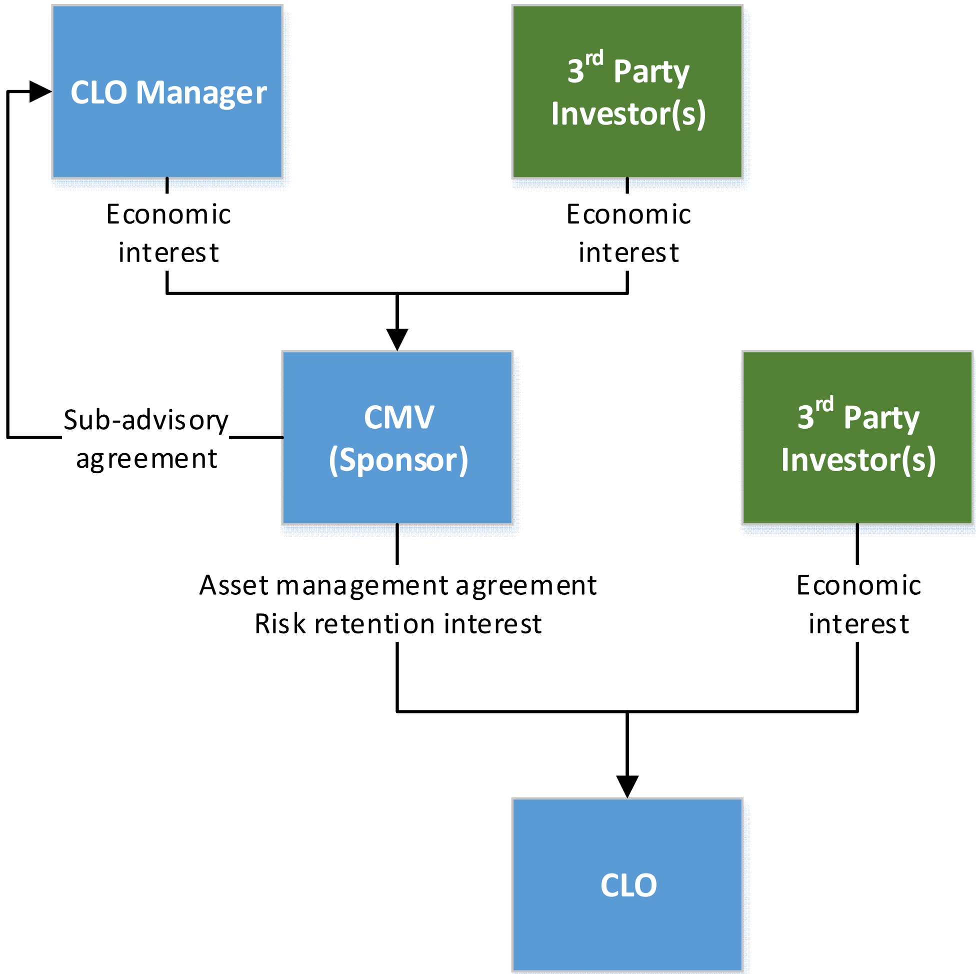
CLO Legislative and Lobbying Efforts

- "Qualified CLO" bill
  - Builds on LSTA comment letter to CRR re-proposal
  - Passed (as H.R.4166) with bipartisan support out of HFSC in February 2016
  - Requires:
    - Asset quality
    - Asset portfolio diversification
    - Alignment of manager and investor interests
    - Manager must be a registered investment adviser
    - Transparency and reporting for investors

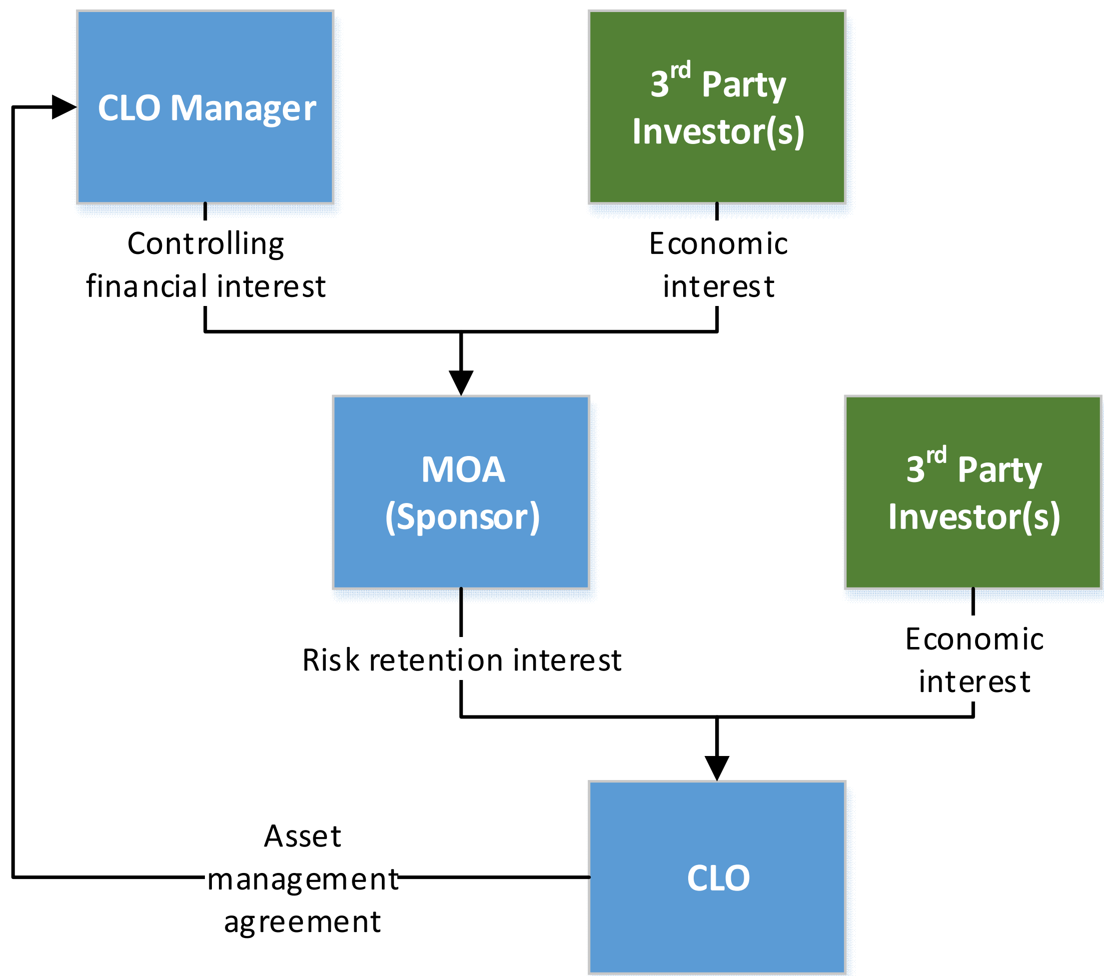
Risk Retention Solutions in the CLO Market

- **Direct capitalization** – CLO Manager obtains capital from a related entity (e.g., its parent) to finance its purchase of risk retention securities and continues to provide management services to CLO
- **Capitalized manager vehicle (CMV)** – CLO Manager raises capital from 3rd party investors through CLO Manager-created CMV to finance its purchase of risk retention securities. Instead of CLO Manager being the asset manager, CMV is the primary asset manager. CMV then hires CLO Manager as sub-advisor. Key accounting consideration is making sure CMV is **NOT** consolidated by CLO Manager
- **Majority-owned affiliate (MOA)** – CLO Manager raises capital from 3rd party investors through CLO Manager-created MOA to finance the purchase of risk retention securities. Key accounting consideration is that MOA **MUST BE** consolidated by the CLO Manager

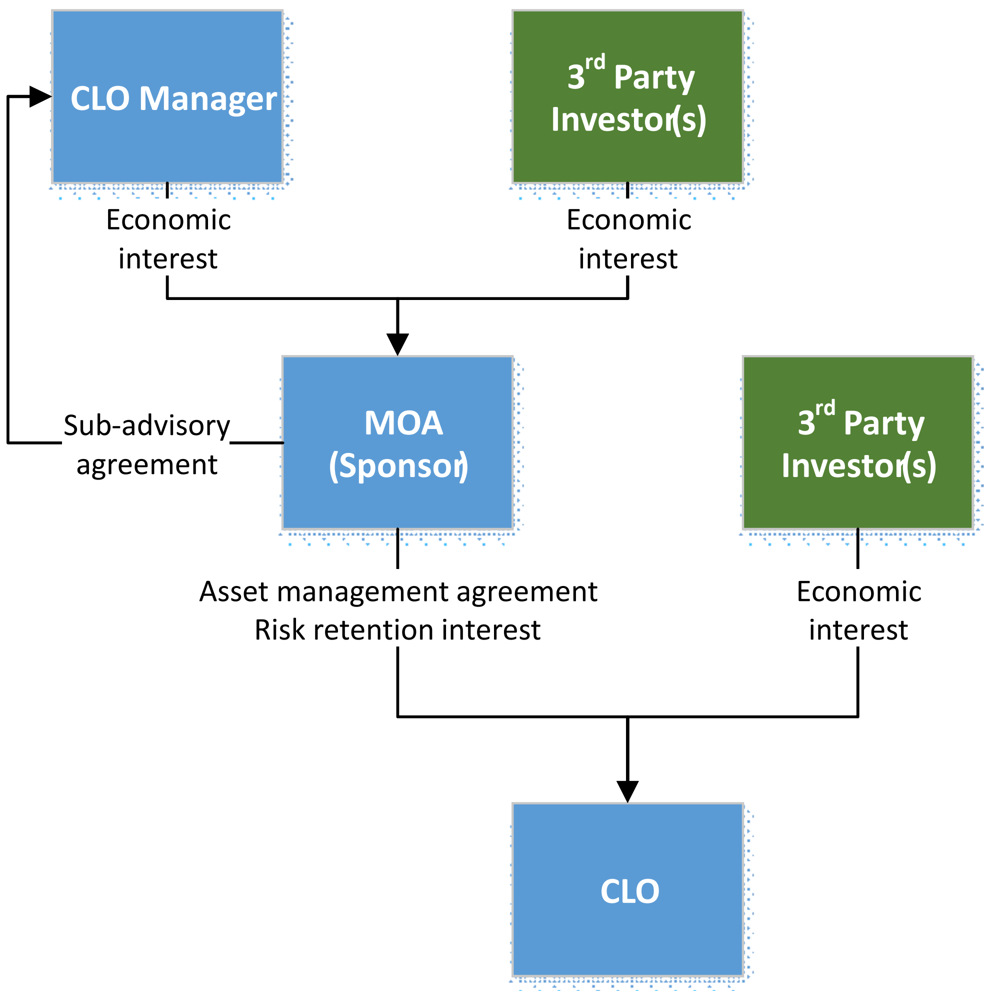
Example – Capitalized Manager Vehicle



Example - Majority-Owned Affiliate



Example – Capitalized Majority-Owned Affiliate



Risk Retention: Fair Value Requirements

- Sponsor of a securitization transaction generally must retain at least 5% of fair value as of the closing date of all "ABS Interests" in the transaction
  – Fair value determination is not required for vertical risk retention or the seller's interest option for revolving pool securitizations
  – Fair value required to be determined using a fair value measurement framework under U.S. GAAP

Risk Retention: Pre-pricing Disclosure of Fair Value

- Sponsor must disclose to potential investors a reasonable period of time prior to sale:
  - The fair value of the EHRI that the sponsor expects to retain at closing (expressed as a percentage of the fair value of all ABS interests issued in the securitization and dollar amount)
  - If the specific prices, sizes or rates of interest of each tranche of ABS are not known, the sponsor may disclose a range of expected fair values based on a range of bona fide estimates or specified prices, sizes or rates of interest
    - If disclosing a range of fair values, sponsor must disclose the method by which it determined any range of prices, tranche sizes or rates of interest

Risk Retention: Pre-pricing Disclosure of Fair Value

- Description of the valuation methodology and all key inputs and assumptions or a "comprehensive description" of such key inputs and assumptions, including (but not limited to):
  - Discount rates and the basis of forward interest rates used
  - Loss given default; default rates and lag time between loss and recovery
  - Prepayment rates
  - If description includes a curve(s), a description of the methodology used to derive the curve(s)
  - Summary description of reference data set or other historical information used to develop key inputs and assumptions

Risk Retention: Post-Closing Disclosure of Fair Value

- A reasonable period of time after closing, sponsor must disclose fair value using actual sale prices and final tranche sizes
  - To the extent the valuation methodology or any key inputs or assumptions that were used to calculate fair value prior to sale differ from the methodology or key inputs and assumptions used to determine fair value at closing, a description of those material differences

Fair Value Measurement Framework

- ASC Topic 820 defines fair value as:

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair Value Measurement Framework

- Additional key concepts around “fair value”:
  - Exit price
  - Principal / most advantageous market
  - Market participants
  - Orderly / active market
  - Measurement date
  - Valuation techniques
  - Fair value hierarchy

Fair Value Measurement Framework

- Market Approach
  - A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.
- Cost Approach
  - A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
- Income Approach
  - Valuation techniques that convert future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

Fair Value Measurement Framework

Fair Value Hierarchy

- Level 1
  - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.
- Level 2
  - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3
  - Level 3 inputs are unobservable inputs for the asset or liability.

Accounting Advice Options

- Why engage accountants for advice on application of consolidation or fair value guidance?
  - There are several sections of the risk retention rules that reference generally accepted accounting principles (GAAP). The two most significant references are:
    - In section _.2 the term majority-owned affiliate (MOA) is defined as

      "…an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50 percent of the equity of an entity, **or ownership of any other controlling financial interest in the entity, as determined under GAAP.**"
    - In section _.4(a)(2) the required 5% eligible horizontal residual interest is determined by reference to "a fair value measurement framework under GAAP".

Accounting Advice Options

- Why engage accountants for advice on application of consolidation or fair value guidance? (cont'd)
  - To make a determination that a structure is compliant with the risk retention rules, a manager may wish to engage accountants to provide advice on GAAP.
  - Lawyers may also be engaged to issue an opinion on whether the securitization structure complies with the risk retention rules. To issue such an opinion, they may need a certain level of comfort from accountants on those aspects of the rules that reference GAAP.

Accounting Advice Options

- What type of accounting advice may be obtained for ownership of a “controlling financial interest” in the MOA? (cont’d)
  - Engaging a third party accountant:
    - If the manager has no auditor (or the audit is of the managed funds only), engaging a third party accountant is an option.
      - In these cases, a third party accounting firm may be engaged to issue a “report on the application of accounting principles,” which analyzes whether a controlling financial interest is owned by the manager.
    - Also note that some audit firms may not be willing to issue the separate letter by the engagement partner described above; this may also prompt engaging a third party accountant.

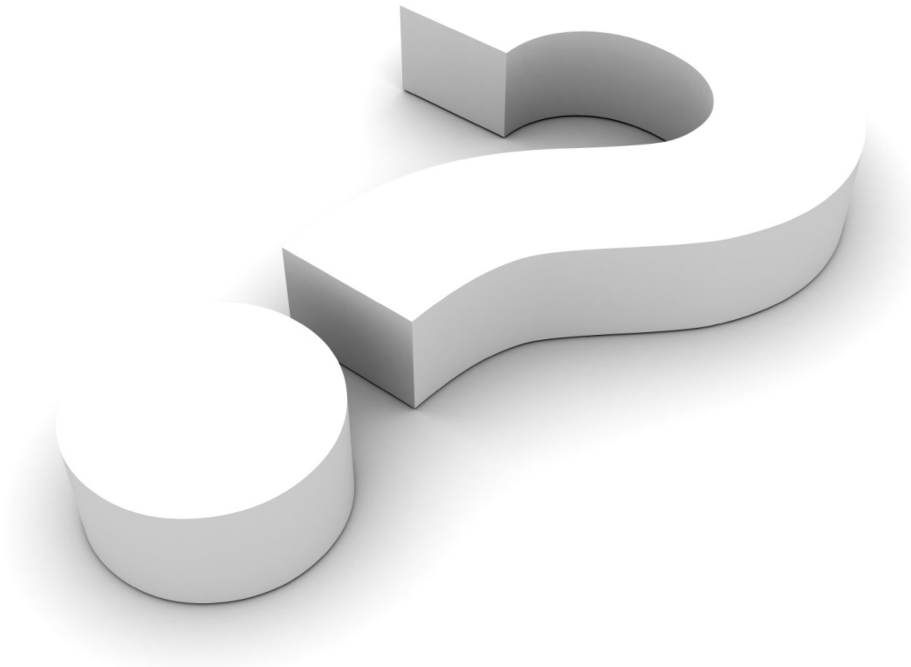
Risk Retention and Legal Assurance

- Third party legal opinions are problematic to deliver
  - Difficult to make a determination as to how the highest court in a jurisdiction would interpret the rules
    - No judicial decisions, very little regulatory guidance and many interpretive issues remain
    - Lack of customary practice; no common understanding of language used in opinions or customary expectations regarding diligence
  - Analysis relies on facts and, in some cases judgments on GAAP (fair value and controlling financial interests)
- Compliance burden is on sponsor; no obligation on counterparties to comply with risk retention rules

Risk Retention and Legal Assurance

- Emerging consensus of ABA Task Force
  - "no violation of law" opinion not appropriate to give, even a reasoned opinion
  - negative assurance re disclosures should be appropriate and feasible
    - Nothing has come to the attention of counsel that caused them to believe the disclosures contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements , in light of the circumstances in which they were made, not misleading
- Does not rule out written advice, memos and perhaps opinions to clients

QUESTIONS



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Fitch Ratings

Managing CLOs Through the Cycle

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Moderator:

Kevin Kendra, Managing Director, Fitch Ratings

Panelists:

Matthew Andrews, Managing Director, Head of Structured Credit, CIFC Asset Management LLC

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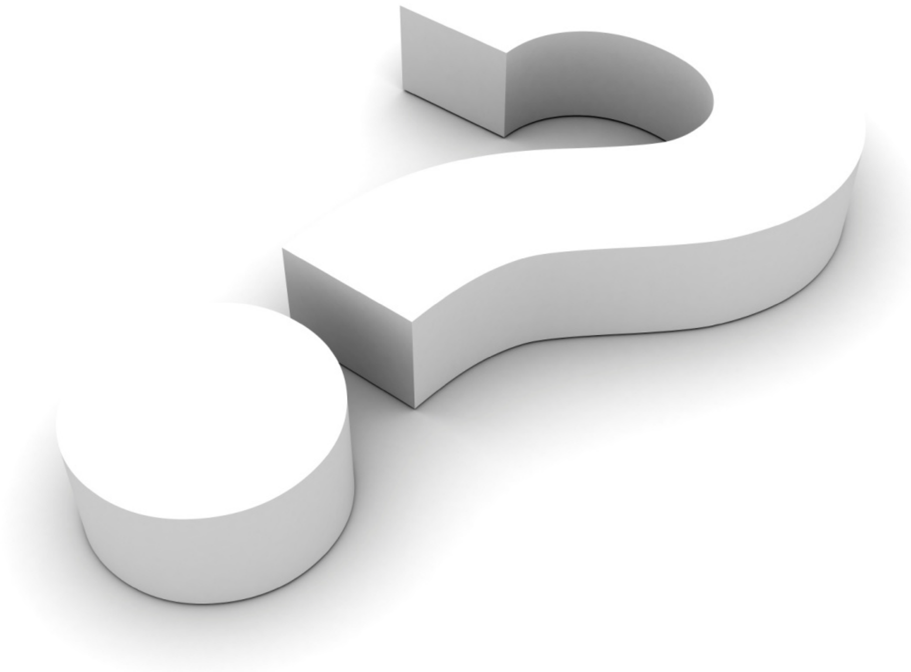
Keith Oberkfell, Partner, Mayer Brown

Alina Pak, Senior Director, Fitch Ratings

Eddy Piedra, Vice President, Creek Source Capital/4086 Advisors

QUESTIONS



Closing Remarks

Kevin Duignan, Managing Director, Fitch Ratings

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