

Collateralized Fund Obligations: A Primer

Collateralized fund obligations (“CFOs”) emerged in the early 2000s as a means of applying securitization techniques developed for collateralized debt obligations (“CDOs”) to portfolios of hedge fund and private equity fund investments (each, an “Investment”).

CFOs allow portfolio investors, secondary funds and funds of funds (each, a “Fund Investor”) an alternative and diversified capital markets financing solution and, potentially, a means of earlier monetization of their holdings. This article reviews the basic structures and features of a CFO.

The core concept of a CDO is that a pool of defined financial assets will perform in a predictable manner (that is, with default rates, loss severity/recovery amounts and recovery periods that can be reliably forecast) and, with appropriate levels of credit enhancement applied thereto, can be financed in a cost-efficient fashion that captures the arbitrage between the interest and yield return received on the CDO’s assets, and the interest and yield expense of the securities (the “Securities”) issued to finance them. Each of Fitch, Moody’s, Standard & Poor’s and DBRS, Inc. have developed CDO criteria and statistical methodologies and analyses to ‘stress’ a pool of specified CDO assets to determine the level of credit enhancement required for their respective credit ratings for the Securities issued to finance such pools. These same concepts apply for CFOs and a number of CFOs were consummated prior to the financial crisis.

In a CFO, a bankruptcy-remote special purpose entity (the “CFO Issuer”) purchases (or acquires directly) and holds a diversified portfolio of Investments. To finance the purchase, the CFO Issuer issues tranches of Securities secured by these assets. The majority of the Securities issued are debt instruments, with only a small portion consisting of equity in the CFO Issuer. Each tranche (other than the junior most tranche) has a seniority or priority over the other tranches, with “tighter” collateral quality tests that when triggered divert all interest and principal proceeds that would otherwise be allocable to more junior tranches to only the more senior tranches. This tranching capital structure allows an investor in the Securities to determine its preferred risk/return investment and an opportunity in the junior CDO tranches for enhanced returns due to the leveraged structure of the CFO.

Credit enhancement in the CFO is provided through overcollateralization, primarily through eligibility criteria and concentration limits. The rating agency methodologies in certain transactions have (at least in part) required that Investments be seasoned for some minimum tenor and that they be sponsored by fund managers (“Sponsors”) with a history of favorable performance. In addition, the rating agencies have required concentrations around “diversity” of Investment by style (i.e., early/late stage venture, buy-out, mezzanine, special situation, etc.), by industry and by commitment “vintages.”

In addition, one pre-crisis CFO even had an unusual two-tier overcollateralization test that became more stringent if a trailing 12 month volatility of the portfolio test exceeded certain specified levels. As with similar asset classes, the rating agency requirements for CFOs will inevitably change and evolve as the agencies gain more experience with them.

CFOs contain two primary structuring challenges. First, since many Investments will not have specified or consistent periodic payments (and may themselves be leveraged with senior secured and mezzanine debt), the dividends and other distributions on such Investments are difficult to predict and model. Thus, the capital structure of the CFO Issuer cannot not include significant current interest or other payment obligations (i.e., the CFO Issuer must issue zero coupon Securities) or must include a liquidity facility, cash flow swap or other similar arrangement to “smooth” cash flows to ensure timely payment of CFO liabilities. In addition, the typical private equity Investment requires an investor (in this case, the CFO Issuer) to commit to make capital contributions to the Investment in a maximum amount from time to time when called. As a result, unless such Investment is fully funded prior to being acquired by the CFO Issuer, the capital structure of the CFO must include available capital with sufficient flexibility (such as a revolving credit facility or a delay-draw tranche) to allow the CFO Issuer to make the required capital contributions.

Coming out of the financial crisis, we are seeing increased interest in CFOs. Fund Investors are attracted to the diversification of funding source, as well as the potential for longer term financing availability in the capital markets compared to the bank markets. CFOs allow such Fund Investors to realign their portfolios, freeing up capacity for additional Investments with favored Sponsors or rebalancing portfolios to desired Investment styles, industries or vintages. In addition, CFOs may offer certain institutional Fund Investors an opportunity for regulatory capital relief, as an Investment portfolio can be “exchanged” for CFO Securities that in the aggregate require such Fund Investor to hold less capital under applicable regulatory requirements since the senior tranches will be highly rated. Although we do not currently see an active market for the equity portion of CFOs, if it were to develop, CFOs could certainly provide an alternative liquidation solution to the more standard portfolio secondary sale. While we do not forecast a major uptick in the CFO market in the latter half of 2013, we do expect issuance to gradually increase to its pre-crisis levels, as investors look for attractive and more tailored opportunities. We see this as a positive for the market generally, as they offer increased liquidity, diversification and the potential to improve the transparency of their underlying Investment markets.

For more information about the topics raised in this Legal Update, please contact Paul Forrester.

Paul Forrester

Senior Counsel

1 312 701 7366

jforrester@mayerbrown.com

Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world's three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our "one-firm" culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience.

Please visit mayerbrown.com for comprehensive contact information for all our offices.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England & Wales), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) and non-legal service providers, which provide consultancy services (collectively, the "Mayer Brown Practices"). The Mayer Brown Practices are established in various jurisdictions and may be a legal person or a partnership. PK Wong & Nair LLC ("PKWN") is the constituent Singapore law practice of our licensed joint law venture in Singapore, Mayer Brown PK Wong & Nair Pte. Ltd. Details of the individual Mayer Brown Practices and PKWN can be found in the Legal Notices section of our website.

"Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2023 Mayer Brown. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.