

Collateralized Fund Obligations: A Primer

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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.

Endnotes

- ¹ Paul Forrester is a respected corporate finance and securities lawyer whose practice is especially focused on structured credit, including collateralized loan obligations, energy (including oil and gas, utilities, shipping, refinery and pipeline) financings and project development, and financing (especially concerning renewable energy, industrial, petrochemical, power and transportation projects and infrastructure).

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