ALCENTRA

Opportunity knocks as US and European CLOs diverge

Alcentra's global head of structured credit **Hiram Hamilton** answers questions about opportunities in CLOs, and why the US market is materially underperforming

London-headquartered Alcentra Group is a sub-investment grade corporate credit investor, managing $28 billion in total AUM with $16 billion of assets in non-investment grade leveraged loans on both sides of the Atlantic. The firm currently has around $7 billion under management in the US and $9 billion in Europe, with further investments in high yield bonds in the States amounting to another $3 billion.

Around that core business the firm has been developing a number of alternative strategies, including its direct lending business, special situations/corporate distressed investing as well as its structured credit investment business

Hiram Hamilton, the firm's London-based global head of structured credit, says: "When we refer to structured credit investing, for us we principally mean corporate credit-backed securitisations and in particular CLOs (collateralised loan obligations). Although structured credit assets for others include RMBS, CMBS and consumer backed securitizations, we are somewhat unique in our niche focus on CLOs. The number of underlying corporate obligors of a CLO is actually quite small (circa 100) which to us means you need to have individual views on the underlying corporate loans. That's our approach and where we think Alcentra's core strengths are."

Hamilton joined in 2008 and was previously an executive director at Morgan Stanley and head of the collateralised debt obligation group in London, and he launched Alcentra's first fund investing in CLOs as an asset class in 2009. The firm, owned by Bank of New York Mellon, initially targeted the mezzanine and equity tranches, and last year raised $3 billion for its latest fund targeting higher grade tranches. "We have capacity to invest across the entire CLO capital structure," says Hamilton, "We can invest in senior, mezzanine and equity tranches in both the secondary and primary markets and pick our spots where we see the most value."

Hiram Hamilton

Q Where do you see the greatest market opportunity?

Hamilton: Right now, it's really interesting. There has been a massive dislocation in the US high yield markets and the US loan markets, and consequently in the US CLO markets. We have seen massive price decreases, particularly in junior mezzanine and equity tranches, and many market participants are talking about the opportunity in US CLOs. For many US 2014 Vintage CLO transactions, CLO equity has moved from a mid-80s price point down to 40 , and some junior mezzanine that was trading in the mid-80s at the start of 2015 was in the 50s by the end of the year.

The lower prices can be quite tantalising for prospective buyers and looking at the last crises, many of the pre-2008-CLOs (also known as "1.0" CLOs) have mezzanine and equity tranches which performed well despite a jump in defaults in 2009. With this backdrop, you can see why some participants think this is another turn at that opportunity.

When we look at the situation, our funds are global, and we remain cautious on US CLOs. Instead, where we see the real opportunity at the moment is in European CLOs. European CLOs have also widened in sympathy with US CLOs but without the same underlying credit problems. We have seen a divergence in the underlying fundamentals of US CLOs and European CLOs, with the US materially underperforming.

Q What is driving the divergence between the US and European CLO markets?

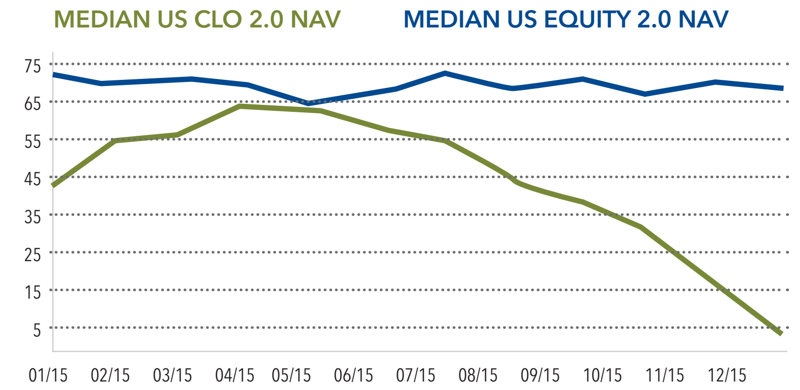
Hamilton: One of the main differences between the US and Europe is this concentration of energy and commodity-linked companies in the high yield market in the US. We have seen such a big repricing in natural gas, oil, iron ore and other commodities, that so many companies whose capital structures were set up when those prices were three times what they are now are very over-leveraged, and consequently those loans have dropped in price.

Today, the average CLO portfolio in the US comprises more than 15 percent of its assets trading below a price of 85. That is a lot of corporate stress and it's not just confined to oil and gas and metals and mining with many retail and technology sensitive business (e.g. radio) suffering. In energy and commodity linked corporates, we are concerned with the recovery rates associated with those loans. Historically, leveraged loans have had high recovery rates, but they may be much lower because the commodities have repriced to such an extent.

In the US, we think it's too early to invest in the most junior tranches of CLOs because there is a real risk that some of these will PIK interest (defer interest payments) as a result of coverage test breaches which would lead to further lower prices. In the near term, we feel it is a bit early, although there will be an opportunity longer term higher in the capital structure.

In comparison, Europe is an importer of energy and commodities, and is a clear net beneficiary of lower energy costs, both from the company perspective and the consumer perspective. The other big difference between Europe and US is the part of the economic cycle that Europe is in. Quantitative easing feels like it has been going on for a long time, but in Europe it has really only been around for 12 months and in the US it went on for four years. So we are two or three years behind the US, which means ongoing support will keep interest rates low, which is good for keeping companies going, maintaining liquidity, and also keeping the European currency more competitive.

RELATIVE VALUE CURRENTLY FAVOURS EUROPEAN CLOS



Source: Citi Research and Alcentra, January 2016. CLO equity NAV is calculated by taking the market value of the loan collateral, subtracting the par value CLO debt liabilities and dividing the result by the size of the CLO equity tranche.

The currency is a big factor, because while many viewed the weakening euro as a red flag, we felt it was a net credit positive for European high yield companies as their exports became priced more competitively in global markets and any non-euro denominated revenues received the benefit of appreciation when translated back.

Of course the two markets are correlated, and in Q1 of this year there has been material widening in European CLOs. However when we look at the European CLO portfolios, we don't see the wave of triple Cs and defaults coming in Europe that we see in the US. In February, we saw the first CLO downgrade in the US and we expect more in the next six to nine months. Our portfolios have about 0.5 percent oil and gas exposure in Europe, whereas it may be 4-5 percent in the US, with metals and mining on top of that.

Q Are Europe's credit fundamentals truly robust?

Hamilton: In the near term, with recent ECB QE actions, depreciated EURO and low/negative rates, Europe offers relative value. When you look at the signs, new car sales in the UK in January were the highest since 2005 and on the continent we have seen 28 months of increasing new car sales. We see fewer fundamental issues in the leverage loan market, in large part due to less exposure to metals and mining and oil and gas.

The US CLO market is much larger than its European counterpart, with $98 billion of new issuance in 2015 as against €12 billion in Europe. That means that in years where there is a lot of money flowing in, there is likely greater pressure on underwriting standards in the US than there is in Europe.

One negative point about Europe was the amount of high yield bond issuance done over the last couple of years, which was more than had been done previously and some of that was at low ratings. CLOs in Europe are backed primarily by senior secured leverage loans but do have bond buckets and not immune to market volatility.

But for now, we think it's a good time to be in European CLOs where defaults are currently trending downward, while over the medium/long term there is a good opportunity in US CLOs higher in the capital structure given distressed pricing in some of the tranches. ■