Regional reflections

Divergences in risk retention and loan market size can mean making heads and tails of CLOs on both sides of the Atlantic is tough. **Andrew Bellis**, managing director in Partners Group's Americas private debt division, compares the two markets

Q How does the CLO market differ between the US and Europe?

The differences between the US and European CLO markets tend to be driven by the differences in the underlying loan markets. If you look at the European CLO market, investors get exposure to far fewer managers than in the US and the underlying loan portfolios are more concentrated. This is because in the US, the loan market is substantially bigger, in terms of both volume and number of loans, and much more liquid. Syndication is more controlled by investment banks, and there are many, many more players who invest in the market.

Q What benefits do LPs get from investing in CLOs?

I think it depends on which part of the capital structure the LPs are investing in, and also varies by the type of investor the LP is. In general, it is a way for an LP to get a broadly diversified exposure to either the US or European loan markets where they can tailor that exposure based on their risk-return tolerance and other considerations.

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Q Which type of investment in your mind offers LPs the best risk-return profile?

I think it depends a lot on who the LP is and what bucket [in their portfolio] they're investing from. There are certainly investors – large insurance companies, banks and some pensions – that invest in the top of the CLO capital structure. The view here would be that, relative to other AAA-rated assets, a CLO AAA-rated tranche offers a significant return pick-up and so they look at this tranche but more out of a fixed-income allocation.

For other LPs, the bottom part of the capital structure is a way for them to get exposure to the loan market at a much more attractive return because of the embedded leverage in CLOs. Given the significantly higher target returns, this may well come from an alternatives allocation.

It's also interesting in that case that CLO equity has somewhat the reverse characteristics of a private equity J-curve. CLO equity pays cash distributions in the early years, which produces the majority of the return.

Q What are the risks and challenges LPs should keep in mind if they invest in CLOs?

You run the risk of default and loss in the loan portfolio. That ultimately leads to the risk of a reduced return on the investment. When defaults pick up, it hurts the equity returns first and then it hurts the rest of the capital structure. What tends to hurt CLO equity the most is if you have a sustained, high level of defaults early in the life of the transaction. That's really the most punitive scenario for equity returns.

The other risk is the potential mark-to-market volatility for investors, particularly if you're investing in the mezzanine part of the capital structure. There can be fairly significant price moves in those assets. Some investors care a lot about mark-to-market volatility, some investors don't because they view it as a buy-and-hold strategy.

Q Are there certain things investors can look for when evaluating how individual managers handle risk?

Investors will have a view on the style of managers they like or don't like. Certain investors prefer a more conservative manager where they view it's more likely that they will get their low-double-digit CLO equity return in their portfolio over a manager that takes more risk in managing the portfolio. Some CLO managers may trade the loans more frequently, buy riskier loans, buy loans that potentially trade at a discount or are CCC-rated. You might ultimately have a higher headline return, but there's a lot more volatility associated with that.

Andrew Bellis

Q How do managers deal with the concerns around risk retention?

I think the basic assumption is that the US risk-retention issue has gone away. In Europe, the whole market is subject to risk retention. From the manager perspective, it still plays a barrier to entry in Europe because you must satisfy risk retention rules to issue what is effectively a European CLO because you're going to be dealing with European investors.

In the US, because risk retention has gone away, there is probably less of a barrier to entry. Where I think it gets a little murky is, if you're doing a US CLO and you want to sell it to European investors, you must comply with European risk-retention rules and so the benefit of doing that will need to be assessed. Generally, because of those differences, the markets are developing differently in terms of who invests in the transactions. For US CLOs, the investor base is almost exclusively US or Asian; for European CLOs, the investor base is almost exclusively European with some Asian investors.

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Q What other regulatory headwinds or tailwinds do you come across?

In terms of the CLO market or loan market in general, regulation is going away or easing off in the US, if you look at how leverage rules are going to be applied for the banks, for example, and the roll back of risk retention. For Europe, nothing has really changed. Regulation has come in and is pretty much here to stay. So we have a divergence on where regulations are headed in the US and Europe.

Q How does an LP's CLO portfolio work alongside its private debt investments?

I think it depends on how investors bucket CLOs in terms of their allocation. A lot of investors may view CLO equity differently to a traditional private debt fund investment.

In a private debt fund, you're seeking to generate extra return because you're investing in highly illiquid assets. In a CLO, you're using more "liquid" investments, generally the debt in larger companies that is syndicated. Therefore, it has a lower return, but you're using structural leverage to enhance that return.

The more leverage you take on, the less risk you want to take on the asset side. In a CLO, that's why you stick to a diverse portfolio; it's first lien, senior secured risk because you need the stability on the asset side because of the leverage you run.

In a private debt fund, you often see potentially more junior or smaller company investments because you generate that higher return through the additional risk at the asset level rather than through the additional risk of the leverage on the structure. ■