Lead Left Interview – David Preston

THE LEAD | June 10, 2014

This week we speak with David Preston, managing director in the Structured Products Research group at Wells Fargo Securities. David covers CLOs, CDOs and Commercial ABS, and publishes a widely-respected report, *The CLO Salmagundi*.

The Lead Left: *David, CLOs were left for dead last year with all the regulatory pressures they seemed to be facing, but we're seeing $1 billion vehicles and near-record volume. What's going on?*

David Preston: CLOs are very efficient vehicles for asset managers to raise AUM. Risk retention rules aren't scheduled to take effect for two years, so if you think that'll inhibit your ability to issue CLOs, you'll rush to get them in before the deadline. Managers will try to launch as many as possible.

TLL: *How has CLO performance been, especially through the credit crisis?*

DP: The value has been attractive and performance history has been strong through severe stress, right through the most difficult cycle. We have more data that demonstrates that. So that's why investor demand is so high.

TLL: *How would you characterize the default behavior for CLOs?*

DP: We have twenty years of default history, thanks to S&P, covering 1,000 CLOs and 6,000 tranches. 65% of the universe of rated tranches are still outstanding, meaning that the rest have been paid in full. Of all the CLO tranches ever issued, only 0.41% have defaulted.

TLL: *How does that compare to corporate defaults for a given rating?*

DP: CLO tranche defaults have performed better than their similarly rated corporate counterparts. As an example, single-A CLO tranches had a 0.45% default rate, compared to 0.82% for similar corporates. And I would point out that most of the defaulted single-A CLOs were special situation vehicles.

TLL: *So investors should be very bullish about this asset class.*

DP: The investor base is certainly expanding since the credit crisis, thanks to the work that's been done educating investors on the value proposition.

TLL: *Of which you and your team have been on the forefront.*

DP: Thanks. It's understanding the value of being at the top of the capital stack. Also, the regulatory hurdles you mentioned earlier are real. Banks are taking a step back, thanks to the Volcker Rule.

TLL: *So where are triple-A investors coming from?*

DP: Insurance companies and money managers are coming in.

***TLL:** It used to be just JP Morgan and a couple Japanese banks. How many are in that universe now?*

DP: Probably more than twelve.

***TLL:** That's an improvement. And what are triple-A spreads today?*

DP: For broadly syndicated CLOs, it's about L+150. For middle market, the range is L+165-185.

***TLL:** How does that compare with triple-A corporate spreads?*

DP: We use the investment grade index, which is close to a triple-B. That's in a range of L+60-70 bps. A better comp would be the senior tranche of CMBS, though that's a fixed rate so it's not a perfect comparison. The equivalent spread to swaps would be T+80-85.

***TLL:** Why is there such a wide disparity?*

DP: CLOs are a more complex investment to analyze. Other ABS are more standardized. For example, those securities have no manager; CLOs require active management. Also, there are more regulatory issues. It costs more for banks to own a CLO, and they are less liquid than CMBS. Finally, they are callable in two years, meaning the CLO can be refinanced away from an investor, which can be a hurdle.

***TLL:** How about middle market CLOs? How's issuance been?*

DP: We've seen $3 billion so far this year…

***TLL:** Wait, sorry, David. Help us define 'middle market' for the kind of loans that go into those CLOs.*

DP: First we look at size of loans and borrowers. Next at the number of lenders. Then we ask who's originating the loans. The issuer tends to also be the originator. After that we look at the Moody's Diversity Score. Middle market tends to have lumpier portfolios. Finally, middle market loan prices tend to be less transparent.

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