Lead Left Interview – David Preston _ Part Two

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This week we continue our conversation 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.* Second of two parts – View part one

The Lead Left: *OK, thanks. So you were saying on volume…*

DP: Yes, so $3 billion, which compares to $46 billion of total issuance. That's about 7%, compared to last year of 6.5% and 2012 of 4.5%.

TLL: *Given all the middle market platforms emerging, you'd think CLO issuance would be more robust.*

DP: It's harder to put together an experienced team, for one thing. Plus it takes time to find the assets. You can't pick them off the screen. Middle market activity more often suffers from natural breaks in supply. So in general, there are fewer barriers to entry for BSL managers.

TLL: *Post-crisis CLO structures were designated 'CLO 2.0.' Are we still in that phase?*

DP: The 2.0 models began around 2010 and were more conservatively structured than the pre-crisis versions. You're beginning to hear '3.0' now, meaning they are Volcker compliant. There's a lot more customization and innovation now. That includes step-ups in coupons, and longer reinvestment periods.

TLL: *Are we back to CLO 1.0s?*

DP: Not all have the same structural features as those originals. But more do. For example, two-thirds now carry single-B tranches.

TLL: *So what are CLO managers looking for?*

DP: There's less structural innovation for middle market CLOs. And each one is different. Some managers are originating 9-10% yielding assets, which require more credit support. And those vehicles tend to be less leveraged.

TLL: *Where is middle market CLO leverage compared to BSL?*

DP: BSL is around 10x, with equity representing 9-10% of the capital structure. For middle market, leverage is in the 6-7% range, and equity is about 15% of the structure.

TLL: *What does that translate into in terms of equity returns?*

DP: If you buy BSL equity today, you can get 5-6 percentage points per quarter in the beginning, or 20-25 per year. All in, CLO equity can provide high single-digit, low-double digit returns.

***TLL:** You mentioned the Volcker Rule. What's going to be the impact of that for CLOs?*

DP: The market is trying to come to grips with what it means. For 2012-13 issues it means removing any bonds from assets in the structure. You're allowed 5% – the average holdings for those vintages is about 2%. Plus you need an amendment to restrict the CLO from buying bonds in the future.

***TLL:** What else?*

DP: After July 2015 non-compliant tranches will likely trade at a discount. After all, who would want something they can't trade?

***TLL:** Is there any significance to these $1 billion CLOs that are coming to market?*

DP: (laughing) Other than we all like big numbers?Demand is high because the investor base is growing. Middle market CLOs do have an advantage of having managers typically retain the equity. They can be sold to European investors; US risk retention rules haven't been enacted yet.

***TLL:** What will be the biggest surprise of 2014, and 2015?*

DP: I think there will be more cracking down from regulators on leverage lending. CLO people won't have focused on that. That could really limit supply.

***TLL:** But won't the non-banks sop up demand?*

DP: Yes, but now you're getting out of the area of my expertise!

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