Talking control

CLO equity is back in vogue and is attracting attention for all the right reasons. Indeed, as **Mark Pelham** discovers, for suitably prepared investors, taking a majority position can increase the benefits still further.

After years of uninformed press coverage setting up CLO equity as the catalyst for the next financial crisis, the bottom of the stack is now back in favour. Not least with most bank structured finance research desks, where it was pretty much everyone's top tip for 2022.

For those who understand the sector, that is no surprise, and there is an argument for increasing investment in deals for which due diligence has already been undertaken. Undoubtedly a control equity stake offers many advantages, but taking such a leadership role is not for everyone.

"CLO equity performance in 2021 was very good historically, any way you look at it," says Daniel Wohlberg, director at Eagle Point Credit Management. "A strong rebound in loan prices from COVID-related volatility and a fair difference between loan spreads and CLO debt spreads invites many investors into the asset class from the sidelines today." ▶

Daniel Wohlberg, Eagle Point Credit Management

While Wohlberg is pleased to see growing interest in CLO equity investments, he stresses the need for caution before moving in full force. "People forget the immense diligence challenges and friction costs that come along with managing large blocks of CLO equity," he says.

"For example, CLO collateral managers tend to pitch you on their default performance without mentioning par loss or market their cash-on-cash equity returns instead of internal rate of return. Equally, a misunderstanding of rating agency drags or arranging dealer specialities in navigating issuance or refinancing optionality adds many pitfalls for the uninitiated," says Wohlberg.

"To really get the full benefit of control equity, you need to have the right resources in place," says Miguel Ramos Fuentenebro, co-founder of Fair Oaks Capital. "It involves negotiating the structure, so you have to have structurers on board; in-depth analysis of the portfolios, so you need to have a team of analysts familiar with the loans; a thorough review of the legal documentation; and more. So, all of that really points to a more specialist manager."

For its own part, Fair Oaks Capital has been a strong proponent of control equity since the firm launched in 2014. While the firm's investor presentations have obviously evolved since then, the pages on control equity and its benefits throughout the investment process remain largely unchanged.

"You get some benefits from day one," explains Ramos Fuentenebro. "The simplest of which is the impact on the economics of the transaction. If you can commit to underwriting an equity piece, that is clearly seen by the manager and the arranger as a significant reduction of risk and potentially time to market. Consequently, you can have a sensible conversation about the right level of management and arranger fees."

He continues: "Even more importantly than the fees, control equity gives you a say in both a deal's structure and its portfolio. In structural terms, it is understandable that a manager may favour the longest reinvestment period to potentially maximise their own economics. While that makes perfect sense for them, from an investor's perspective that's not always necessarily the case."

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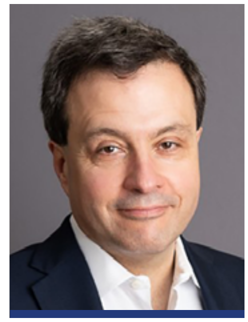
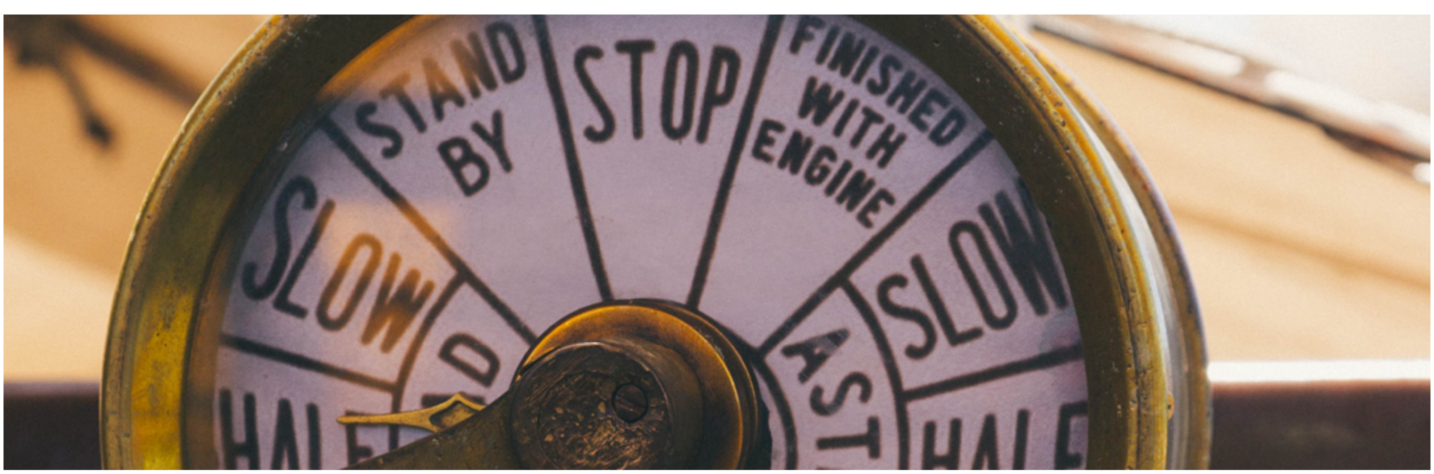
As a control equity investor, Fair Oaks has executed plenty of transactions that are standard and meet the manager's typical goals. However, the role has also enabled it to bring to market opportunistic transactions, including the first « print and sprint » transaction in Europe, or, at times when the funding for a short maturity and shorter reinvestment period CLO made such deals make sense.



Miguel Ramos Fuentenebro, Fair Oaks Capital

"Ultimately, there is very significant value in being able to design the right structure on day one while retaining control to take advantage of future refi or reset opportunities and this is often not recognised." says Ramos Fuentenebro. "Having a control stake gives you a key say in the decision-making process. Equally, once you get to a point that you want to reset or refi, you can assess the optimal options for the equity. Being in control, you can have a regular dialogue with the manager and implement decisions efficiently and quickly, without the need to find consensus from a collection of minority investors."

The control equity investor's involvement in a deal's portfolio is equally important. CLO



managers often find it difficult to meet the requirements of multiple minority equity holders. Some investors, for example, may want high distributions, so are looking for a high portfolio spread; whereas others could be seeking a more conservative transaction.

Ramos Fuentenebro observes: "A necessary condition to become a control equity investor and to underwrite a transaction is a clear understanding with the manager in terms of what the strategy for the transaction should be. This removes uncertainty and gives the manager the opportunity to discuss future trade-offs. Properly executed Investments by control equity investors should be a win-win situation for both manager and investor."

However, control equity's pre-eminent position can raise eyebrows. "Occasionally, we have had investors ask if this is a slightly confrontational approach and whether we are trying to second guess the manager," says Ramos Fuentenebro. "The reality is that we are not. Obviously, we do the due diligence on the manager and only invest with them if we like their approach and confirm they possess the right team, infrastructure and track-record, but even once they are approved, it is key for the investor and valuable for the manager to have a second pair of eyes on the transaction."

He cites the example of a loan that trades down from par to 95, giving the manager a quandary of how to proceed. "The manager might consider selling it but may hesitate assuming equity investors may not want to see an early par loss," Ramos Fuentenebro says. "Having a dialogue with the control equity investor is helpful because we can confirm our preference and be the first to say, for instance, sell it – we get it, everybody makes mistakes and we'd rather you sell it at 95 than wait for it to go down further. I think that communication with the manager is very, very useful."

So, from initial manager selection all the way down to individual loan management, Ramos Fuentenebro is convinced of the benefits of a control equity holding. "When you look at the kind of target return versus that for a minority equity, you see the benefit of lower fees, the benefit of a potentially more efficient structure, the benefit of getting full control of resets, refis and so on. It's not trivial; it's actually a very meaningful improvement in terms of the return," he says.

"There's nothing ambiguous or speculative about that; that's a fact," Ramos Fuentenebro concludes. "Beyond that, by working with the manager, you may also reduce potential defaults and credit losses and so may still enhance the value more throughout a deal's life, but the benefits from day one are just very clear to us."

CONTROL CALCULATIONS

CLO control equity positions come in two broad forms – a simple majority of more than 50% ownership or a supermajority with a holding of around 90%. With the former, the remaining minority position is usually sold to a number of investors by the CLO arranger in the broadly syndicated market, meaning that the control equity investor doesn't necessarily know all of the other equity investors.

Whereas, with the latter form, the balance of the equity tranche is typically held by the CLO manager, creating a strong relationship between equity investor and manager. Speaking at a roundtable discussion held by Maples Group, Dan Norman, md & head of US business operations at Lakemore Partners, noted: "Our experience suggests that maximising control in a supermajority equity style provides significant benefits that can enhance CLO equity returns."

He continued: "One of the questions we are often asked is: 'what is the quantifiable value of this supermajority control optionality?' In our experience, we see the value of controlling the entire equity tranche to be around 7% to 10% (in absolute terms) in incremental equity return compared to a minority position. We find that a higher level of control leads to a materially higher level of incremental IRR."

The full Maples Group CLO roundtable can be found **here**.

> "OBVIOUSLY, WE DO THE DUE DILIGENCE ON THE MANAGER AND ONLY INVEST WITH THEM IF WE LIKE THEIR APPROACH"

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