CapitalStructure™
A Fitch Solutions Service

Structured Finance - Market Commentary -

SF Performing

CLO INSIGHT: Ellington eyes secondary, mis-rated loans as it looks to bring US CLO strategy to Europe.

CapitalStructure

Ellington Management is planning its inaugural European CLO in 2019 – and in doing so it will introduce a distinctive loan investment strategy that it first initiated in the US.

Ellington has launched four US CLOs since 2017 (of which one was a reset). All are notable for their alternative approach to collateral sourcing: the majority of the loans are sourced in the secondary market, where the firm specifically targets first-lien credits that trade at a discount to par and that Ellington believes have the wrong rating from rating agencies. Moreover, the firm's portfolio managers look for collateral that does not necessarily conform to typical CLO portfolio norms.

It is this strategy that the firm intends to replicate with its first Euro CLO.

"CLOs issued by Ellington are a financing trade rather than an AUM gathering exercise," says Rob Kinderman, partner and head of credit strategies at Ellington Management. "We buy loans that we consider to have an attractive risk/reward profile – then use the CLO market as a financing vehicle to give us term financing on those loans."

"Our view is that the loan market is bifurcated – there's a divide between loans that fit into the standard CLO box, and those that do not. Ellington does not want to pursue the same assets as those managers looking for collateral for a standard CLO."

Aside from the collateral, Ellington's CLOs tend to be outliers in terms of leverage. Its US CLOs have lower than average leverage (at around six times) and a bottom-heavy capital structure where the equity counts for around 15%, of which Ellington retains the majority.

"Although our ultimate CLO structure may look a lot less efficient than others, it will allow us to retain flexibility to rotate and invest the portfolio," says Mr. Kinderman.

But while many loans are typically sourced from the smaller end of the broadly syndicated loan market, Ellington's strategy is not to earn extra spread by targeting illiquid collateral. All loans sourced by the portfolio managers must be liquid.

Ellington's US CLOs typically allow a 50% Triple C asset allocation and currently use around half the bucket. About 75% of the loans in those deals have covenants.

Ellington's Europe CLO operations will be headed up by Hekeani Mathieu, who was hired in October 2018 as portfolio manager specialising in European corporate credit. Like many of the staff at Ellington, Ms. Mathieu has a background in stressed and distressed debt, having previously worked at Morgan Stanley and BAML as a credit analyst in their Distressed and Special Situations teams.

Ms. Mathieu comments that while the European loan market is much smaller and more fragmented than the US market, there is a broad range of Single B rated assets in Europe, across several jurisdictions, which are not necessarily a good fit for other CLO managers.

"For some of these loans, the rating agencies will have a snapshot of the current status, but we will be able to take a long-term view and see the potential for positive development further down the line," she said. "There will be some sectors that we do not want to be overweight on, such as energy and retail. But otherwise, all other sectors should offer good opportunities," she says.

Even though many of Ellington's team have a background in stressed and distressed debt, the CLO vehicles are not used for distressed investing: however, a distressed background can help identify technical price movements versus fundamental issues, Mr. Kinderman added.

The investor base is yet to be determined for Ellington's European CLO. Investors in Ellington's US CLOs have tended to come from the typical CLO investor base, or at least a subset of that universe.

"Many of these investors have their own loan expertise or strategies to look at and understand our portfolio," says Mr. Kinderman. "An investor operating purely on ratings being a determinant of collateral quality may be less likely to invest."

The timing of Ellington's European deal launch will largely depend on market conditions. Following turbulence in Q4 2018, arbitrage conditions remain tough for European CLO issuers – with CLO still lagging the recovery in loans.

"Because we are buying collateral that we want to own, we can be more patient on the exact timing of our issuance. We are also playing a slightly different game as we are not chasing the same collateral as other managers, said Mr. Kinderman. "But we would expect to get the European CLO transaction in the market in the first half of this year."

FACT SHEET

Founded in 1994, Ellington has been in the loan market for most of its history, moving into CLOs in 2017.

Ellington has around $7.5bn in AUM and is active across the structured finance and structured credit markets in Europe and in the US. It also has active strategies in mortgages, corporate credit, NPLs and real estate.

The firm has issued four US CLOs (three new issue and one reset).

Ellington CLO I was arranged by Citi and closed in June 2017. The CLO issued Triple A, Triple B, Double B and subordinate notes only, totalling $373.55m. Ellington CLO I was reset in August 2018, at which time its reinvestment period was extended to three years.

Ellington CLO II issued six tranches from Triple A to Double B, plus equity (also arranged by Citi and closed in 2018).

Ellington CLO III added Single Bs and fixed notes to the capital structure (also arranged by Citi and closed in 2018).

The warehouse for the firm's first European CLO – **Ellington European CLO 1 DAC** - opened late last year. ARC Ratings assigned ratings to the Senior Funding Facility and Mezzanine Funding Facility of the deal's warehouse in early January. In its report, ARC highlighted that the indicative portfolio assets demonstrate broad industry distribution with no individual sector accounting for more than 15% of the portfolio: the largest corporate sectors are healthcare & pharmaceuticals (14.5%) and hotels, gaming & leisure (8.70%).

Regional distribution is primarily concentrated in five countries: the UK (21.7%), France (17.4%), Germany (15.9%), the Netherlands (13.0%) and Spain (11.6%).

Anna Carlisle
anna.carlisle@capital-structure.com
+44 (0) 20 7283 3820

Copyright © 2008 – 2019 CapitalStructure Ltd. The copying, replication or redistribution of CapitalStructure content in any form is expressly prohibited without the prior written consent of CapitalStructure Ltd.