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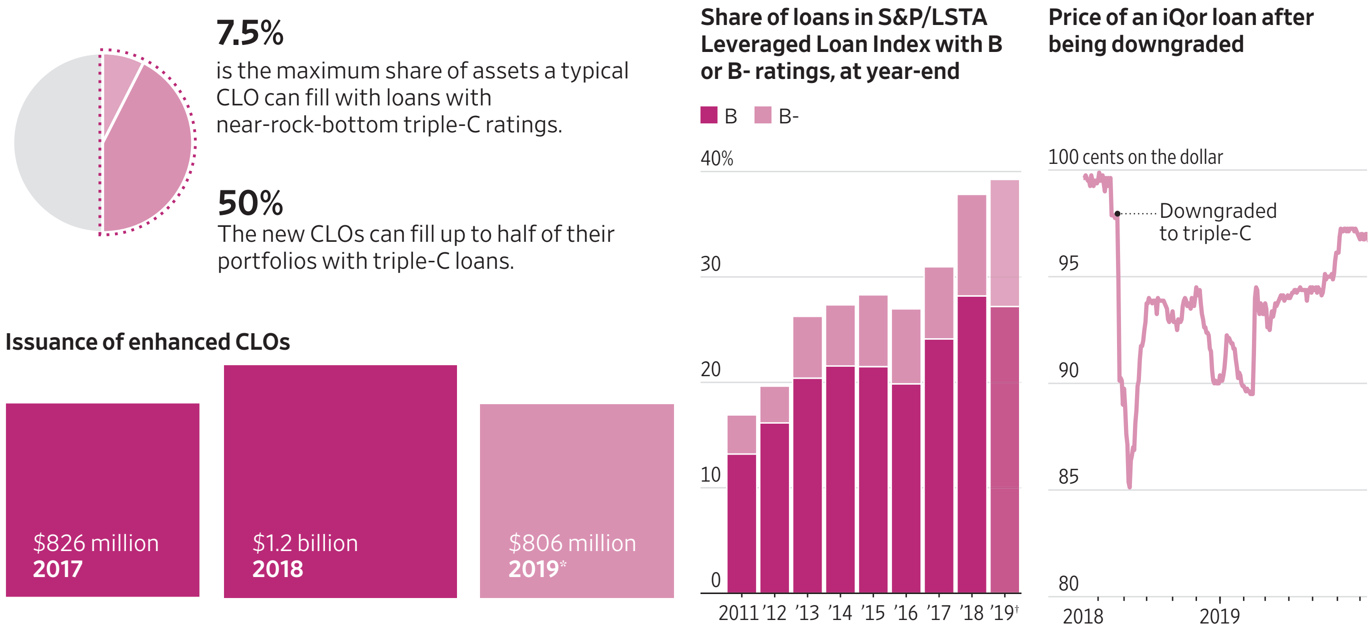
New enhanced CLOs have emerged in response to a decline in loan credit ratings.



*Through July 12 †As of June 30

Sources: WSJ analysis of data from LCD, a unit of S&P Global Market Intelligence (CLOs); LCD (loans with B or B- ratings); AdvantageData (iQor loan)

CREDIT MARKETS

Wall Street's Answer to Risks in Loan Market: Bundle Lower-Rated Loans

A growing number of money managers are embracing a new strategy designed to benefit from volatility in junk-rated corporate loans

By Sam Goldfarb

A growing number of money managers are embracing a new strategy designed to benefit from volatility in junk-rated corporate loans, a sign of building worries about riskier borrowers and the market that supports them.

Since November of last year, three different money managers have issued $1.6 billion of so-called enhanced collateralized loan obligations that are set up to hold a much larger amount of loans with extremely low credit ratings than typical CLOs. At least two more managers are expected to follow suit in the coming months.

The emergence of the enhanced CLOs underscores investors' growing belief the U.S. economy is due for a recession after more than a decade of expansion. It also reflects particular concerns about corporate loans, starting with a decline in their average credit ratings. Since 2011, the amount of loans rated B or B-minus—just above near-rock bottom triple-C ratings—have ballooned to 39% of the market from 17%, according to LCD, a unit of S&P Global Market Intelligence.

As a result, some investors worry that even a modest economic slowdown could lead to a rash of loans being downgraded to triple-C. That could force selling from standard CLOs, which are designed to fill only 7.5% of their portfolios with triple-C rated loans. But it could also create opportunities for the new CLOs to buy the downgraded loans at steep discounts because they can stock up to half their portfolios with triple-C debt.

"I think all sorts of people would agree that we are in the later stages of the credit cycle. And it makes a lot of

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people, investors, nervous," said Serhan Secmen, a structured credit portfolio manager at Napier Park Global Capital, at a recent panel discussion about the new CLOs.

At their essence, CLOs are leveraged investment funds. A typical CLO will issue around $360 million of bonds along with $40 million in equity to fund the purchase of roughly $400 million of speculative-grade corporate loans. Cash flow from the underlying pool of loans are used to pay off the bonds, starting with the highest-rated debt and proceeding to lower-rated bonds. Remaining proceeds go to the equity holders.

Investors say there is ample evidence that the limited ability of CLOs to hold triple-C loans creates unusual price moves in the $1.2 trillion leveraged loan market.

In one example, the price of a loan issued by the business-services company iQor Holdings Inc. dropped from around 98 cents on the dollar to 85 cents last summer immediately after Moody's Investors Service and S&P Global Ratings downgraded the loan to triple-C. Data showed CLO holdings of the loan falling sharply at the time. The loan, however, has since bounced back to around 96.75 cents, according to AdvantageData.

David Kaminsky, chief financial officer at iQor, said the company's "downgrade was dealt with swiftly and with the full support of its lender base. iQor's institutional investors supported the company throughout the process and offered the same terms the company originally borrowed upon when it increased the size of the first lien loan by $40 million in November of last year."

Before November, the only asset manager to issue a CLO that can buy more triple-C loans was Ellington Management Group, which sold three totaling $1.2 billion starting in early 2017. Ellington added a fourth in February.

CLOs that can buy more triple-C loans carry risks. Because they can hold lower-rated loans, the structures pay higher interest rates on the bonds they issue. As a result, returns for CLO equity holders are likely to be below average if a downturn doesn't occur in the next few years, creating the volatility that managers are looking for.

At the same time, such managers also are betting that they can distinguish between triple-C loans that are mispriced and those that are at serious risk of default. Making the wrong bets could lead to losses for CLO investors.

Managers of the new CLOs aren't all pursuing the exact same strategy. While all can fill half of their portfolios with triple-C loans, two of the three—Z Capital Group and HPS Investment Partners—are largely holding back from buying triple-C loans for now to provide more room for buying in the future.

Ellington has been more aggressive, filling roughly 25% to 30% of its portfolios with loans rated triple-C by Moody's. Its theory is that there are many triple-C loans that are already underpriced, and higher-rated loans that are overpriced, partly due to the influence of standard CLOs.

Rob Kinderman, head of credit strategies at Ellington, said his team has particular concerns about the lack of covenants, or investor protections, in most of the loans being purchased by typical CLOs.

Roughly 80% of the loans in Ellington's CLOs have maintenance covenants, which require borrowers to meet certain tests of financial health, even though approximately 80% of loans in the market are missing those requirements.

"I'd rather have a loan that has a technical triple-C rating with covenants all day long" than many slightly higher-rated loans with poor covenants, he said.