



IN\$IGHT

The Next Big Thing: CLOs

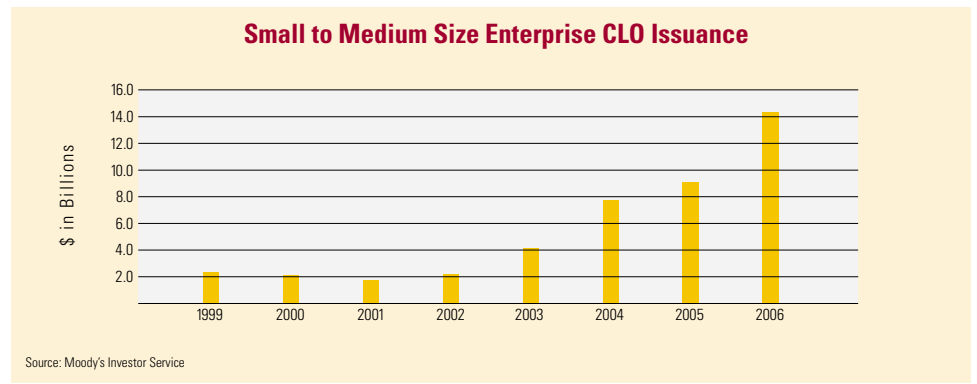
Collateralized Loan Obligations (CLOs) will change the nature of lending relationships.

by Michael T. Newsome

The financial intermediation model for commercial lending is changing. Over the next ten years, structured securitized credit, packaged as Collateralized Loan Obligations (“CLOs”), is anticipated to significantly displace the classical commercial lending system that has dominated banking for centuries. This change will meaningfully impact the banking relationships of middle-market and small business firms.

Historically, banks have attracted capital from depositors and/or investors and channeled those funds to businesses in the form of loans. But, an innovation in asset securitization, known as a CLO, has emerged to effectively reduce both funding costs and regulatory capital requirements, and thereby increase the profitability of lenders originating loans.

Asset securitization, the mechanism of issuing readily tradable securities to investors based upon a pool of illiquid financial assets (mortgages, trade receivables, credit card receivables, etc.) is not particularly new. Robust markets in mortgage and credit card backed securities have operated for more than 25 years. However, securitization has rarely found much direct application to the credit needs of middle-market businesses chiefly because



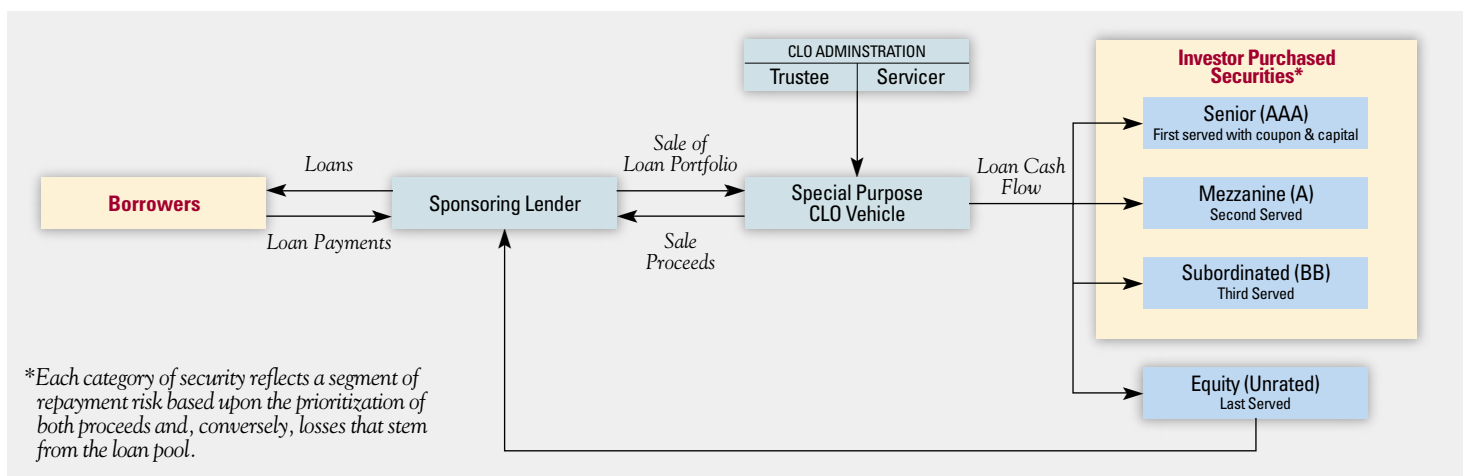
these firms generally do not generate the type and quantity of assets necessary to structure a transaction. Nevertheless, major banks and finance companies have begun to securitize commercial credit (secured and unsecured corporate, middle-market, and small business loans) in the form of CLOs. Of particular interest are CLOs that focus on loans to small and medium size enterprises (SME). This is a minor, but rapidly growing, segment of the overall asset securitization market.

THE BASICS

In concept, a CLO is a pooling of cash flow producing, illiquid commercial loans into a

stand-alone entity. Rights to the consolidated cash flow from the loan pool are prioritized and split into different buckets or “tranches” of marketable debt securities—senior, mezzanine, subordinated and first loss position (equity)—which are in turn each sold to a specialized group of institutional investors.

Each tranche reflects a segment of repayment risk based upon the prioritization of both proceeds and, conversely, losses that stem from the loan pool. The most junior tranche, the “equity”, usually representing 0.5 to 3 percent of the total loan pool, has the last call on CLO cash flow and, thus, the greatest



BANK CLO ECONOMICS						
	Pre-Securitization			Post-Securitization		
	\$ millions	Libor Spread (bps)	%	\$ millions	Libor Spread (bps)	%
Loan Assets	1,000	250	100%	1,000	250	100%
Liabilities						
Deposits & Debt	920	-	92%	800	33	80%
Senior Securities (AAA)				70	80	7%
Mezzanine (BBB)				100	400	10%
Subordinate BB				30		3%
Capital / Equity	80		8%			
Total Liabilities / Capital	1,000	-	100%	1,000	74	100%
Net Interest Margin	25	250		18	176	
Return on Capital before Overhead		31%			59%	

exposure to potential losses. The equity, which is commonly retained by the sponsoring lender, and the subordinated tranche progressively shield the mezzanine and senior tranches from defaults and credit losses. By structuring the allocation of cash flow and risk in this manner, senior and mezzanine securities are accorded high credit ratings from independent rating agencies (Moody's, S&P, or Fitch) and are priced and traded in accordance with their ratings.

WHY SECURITIZE?

The traditional approach of originating and holding loans on the balance sheet until maturity / repayment creates enduring relationships between a bank and its customers. These relationships are not easily terminated without extinguishing the loans. In a broad sense, securitization is the process of transforming illiquid credit relationships into transactions where securities can be easily marketed to and traded within a broad spectrum of investors.

The benefits of CLOs from a lender's perspective are significant. Traditional lending activities are to: (1) originate (find, underwrite and book), (2) fund (hold on its balance sheet), (3) service (collect and apply payments), and (4) monitor (track the borrower's capacity to continue to service) loans. With securitization, these four functions become three—originate, sell and service. This has dramatic implications for the cost structure of a bank. In particular, it reduces the need for highly compensated employees with the analytical skills required to monitor and manage credit relationships.

More importantly, loan securitization lowers overall funding costs. Beginning in 1988 with the Basel Capital Accord, a universally accepted framework was set up for determining the regulatory capital requirements relative to a bank's book of loans. These capital standards motivated the development of loan securitization as a method to transfer the credit risk through the capital markets to third-party investors. In essence, it permits a market-

based determination of the appropriate level of capital to backstop a portfolio of loans, rather than a regulatory mandate. By freeing up regulatory capital, the constraints on fresh lending activities are relaxed. The ultimate benefit has been enhanced shareholder value through improved returns on capital (ROC).

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In a highly competitive market where commercial loan spreads have steadily eroded, it is difficult to justify holding low-yielding loans on the balance sheet against a regulatory capital requirement of as much as eight percent.

As illustrated in the above table, it is more profitable to move a portfolio of non-investment grade loans off balance sheet into a CLO, where the lender retains nearly as much

income with less than half as much capital at risk. As a consequence, major banks and many non-bank lenders are shifting away from using their balance sheets and capital to hold loans and are focusing their efforts on originating, selling, and servicing loans.

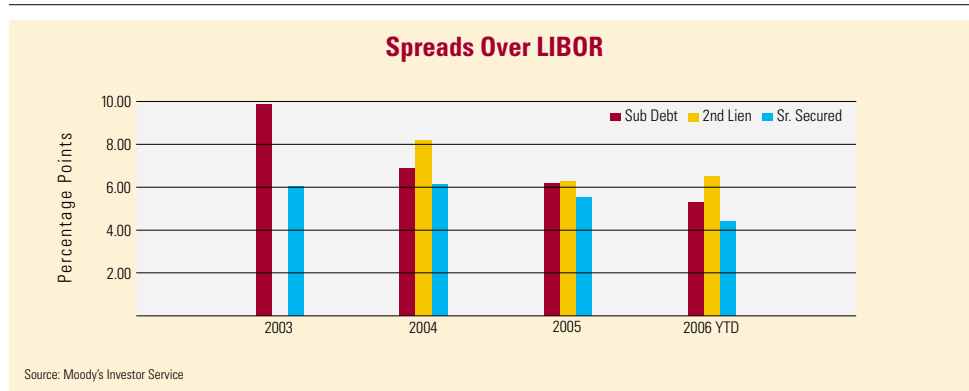
It is important to recognize that asset managers, such as hedge funds, have become active buyers of commercial loans. Their objective is to capture the spread or arbitrage between the acquisition cost of the assets and the resulting value to investors when bundled together in a CLO. In part, this explains why more than 70 percent of broadly syndicated loans are now held by non-bank investors.

IMPLICATIONS FOR BORROWERS

Most middle-market companies are unlikely to be aware that their loans may be funneled into a CLO and have little say in the matter. The trend toward commercial loan securitization is evolutionary, so the signs of change are relatively subtle. Major lenders are using CLO funding cost advantages to win origination opportunities. This is reflected in the increasingly aggressive loan pricing offered in competitive situations. Spend a little time talking to regional bankers, and invariably they will express dismay about how cheap credit has become. CLOs are a contributing factor.

Securitization is also a driver behind the proliferation of flexible new credit structures, such as aggressive senior secured, second lien, and subordinated loans. CLOs have become major funding sources for the leveraged lending activities of banks, investment banks and specialty lenders. Demand for these assets to feed CLOs exceeds supply. Accordingly, on an absolute basis, senior, second lien, and mezzanine spreads over LIBOR rates are high, but have been declining.

Borrowers have benefited from greater availability of risk capital at terms traditionally not offered by commercial banks. As an example, one major Northwest bank has followed a policy of limiting its leveraged lending to companies with historical EBITDA of \$20 million or more. Now in an effort to expand its market penetration, it has set up a CLO that will be used to fund smaller leveraged lending opportunities for companies with EBITDA between \$5 and \$20 million.



The CLO will enable the bank to aggressively compete in this segment of the market without holding the paper on its balance sheet. This may be a formidable strategy.

From a borrower's perspective, the downside of commercial loan securitization is further weakening of the borrower-lender relationship. Fundamentally, securitization shifts

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commercial lending away from long term relationships. The new model is analogous to the public equity market, where the ownership of businesses is securitized into standard financial instruments that are readily tradeable and, therefore, highly liquid. A couple of issues arise. First, CLOs require a relatively uniform set of assets. This entails a steady move toward standardization of loan documentation, covenants, pricing indices, tenors, and risk ratings. It is likely that borrowers will pay a premium for customized credit structures in the future.

The more important issue is how loans are handled if the borrower stumbles and defaults, particularly during an economic downturn when default rates are spiking. There is no historical precedent for this, because the growth in SME CLOs has only taken off in the past few years. In order to protect the credit ratings of the CLO securities, defaulted loans are likely to be removed from the loan pool. The sponsoring lender is unlikely to put the loan back on its balance sheet after its value is impaired, as that would require a protracted workout and incurrence of the regulatory capital hit that it initially sought to avoid. It is more likely that defaulted loans will be sold to distressed debt investors. As discussed in prior *Insight* articles, preservation of value for existing shareholders may be more challenging when all or a portion of the business' debt is held by investors who are accustomed to pursuing a broader range of alternatives for maximizing the value of their investment. While a bank would usually shy away from taking control of the business, that may be the preferred course of action for distressed debt investors.

Overall, the trend toward securitization is a positive one. A broader deeper market, where investors are more proficient at pricing

and managing credit risk translates into greater availability of low cost debt capital. As these activities expand and move down market, the way that banks organize themselves and market their products will change. Lenders will increasingly be evaluated based

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on their skills and efficiency in accessing the market, rather than as a capital supplier and partner for the business. It is not unreasonable to think that, down the road, rather than relationships with lenders, businesses will have relationships with those entities that can best provide access to the capital markets. These may or may not be banks. ♦

Choosing a Private Equity Partner

Do your homework and ask the right questions before deciding on a private equity firm.

by Mark D. Working

Past issues of *Insight* have commented on the advantages of teaming up with a private equity firm in a leveraged recapitalization. This form of transaction provides liquidity for business owners, while assuring the continuity of the organization and management team. The steady proliferation of private equity capital funds makes it likely that owners and managers will have multiple investors from which to choose. If this is a direction appropriate for your situation, there is a whole range of issues that should be considered in the selection of a capital partner for the business aside from valuation.

Know whether the private equity group has readily available capital.

Equity or buyout groups come in two varieties; those that have committed pools of capital, and those that have pledges of capital. The key distinction is who makes the investment decision. In the case of a committed pool, the fund managers have the authority to invest capital on behalf of partners. In a pledge fund, the manager offers an investment to the pledge group of investors and they individually make the decision whether or not to invest. Depending on the particular relationship between the manager and its pledge partners, dealing with a

Issues To Consider When Selecting a Private Equity Partner

1. Know whether the private equity group has readily available capital.
2. Does the prospective fund fit the anticipated transaction size?
3. Your equity partner should have additional resources to bring to the table.
4. Understand an equity partner's investment horizon.
5. Investigate your prospective partner's capacity to support its investments.
6. With whom will the management team and the shareholders be working?
7. How does the equity firm react to stress?
8. What fees will your partner expect to extract from the business?

middleman may make the transaction far more difficult to complete.

Does the prospective fund fit the anticipated transaction size?

It seems like an obvious question, but there

can be a catch. An equity fund will expect that 60-80% of the recapitalization transaction will be funded with debt and the remaining 20-40% of the capital structure will be equity. Typically, an equity fund will limit its investment in a single transaction to no more than 10-15% of its committed capital. So, for a \$100MM fund, the maximum investment would be in the range of \$10-15MM. Given reasonable financial leverage, that would equate to a total transaction in the range of \$30-45MM. Do the math and understand the capital structure before selecting a partner.

Your equity partner should have additional resources to bring to the table.

It is important that the partner you select has the capacity and willingness to invest additional funds in the business when either unexpected opportunities or stumbling blocks present themselves. If your capital partner is out of dry powder at the critical time when additional capital investment is needed, the potentially uncomfortable and costly alternative could be an untimely sale of the business. Moreover, it is wise to have detailed discussions and a clear understanding as a part of the investor selection process about how additional capital would be invested in the business.

Understand an equity partner's investment horizon.

Each equity fund has a finite lifecycle (normally 10 to 12 years) during which funds are invested, investments are nurtured, and ultimately the value that has been created is harvested. Partnership agreements spell out the time period the fund managers have to invest the money, how they are paid, and when the investments need to be harvested. As the fund moves through its cycle, the investment horizon for individual investments becomes shorter. If there is little or no unused capital remaining at the time your company needs additional investment, do not expect an investment from the managers' next fund as they do not like the conflict of having two separate funds invested in the same company at different valuations.

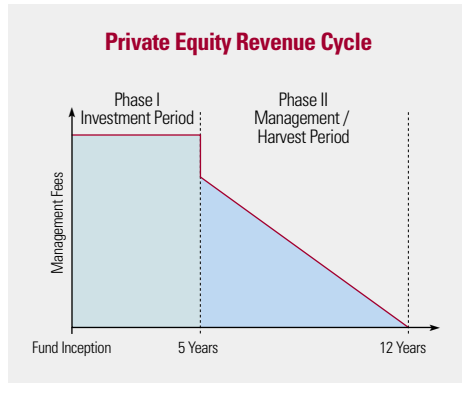
Investigate your prospective partner's capacity to support its investments.

A fund's life cycle and investment horizon has a bearing on the staff and resources available to support the investment portfolio. Operating an equity fund is a costly exercise, principally supported by the annual fees earned by the fund manager from the fund and its portfolio investments. A private equity firm with multiple funds under management and the track record and inclination to raise additional funds is likely to be able to support the overhead associated with maintaining a stable and experienced team to manage and support its investments.

Consider the fee revenue cycle shown in the above chart. In phase I, fund managers typically earn fees as a percentage of total committed capital (whether or not deployed), while they are principally engaged in finding and closing investment opportunities. At some point, as committed capital is substantially deployed (often near the 5-year mark), the emphasis turns to managing and harvesting the stable of investments that has been assembled. As Phase II begins, the management fee is reset, predicated on the actual dollars invested. From that time forward, the fund manager's revenue stream declines as the investments mature and are harvested. If the fund's investments are successful, then the manager earns a share of the gain (typically 20%). If a firm is unsuccessful or manages only a single fund, pressure will mount to cut expenses as the revenue stream declines and this could affect the support you expect from the organization and the stability of the people you think of as your partners.

With whom will the management team and the shareholders be working?

As a transaction develops, a number of



people from the equity group have roles in underwriting, negotiating and closing the investment, but not all of these folks are likely to be involved on a continuing basis. You need to know the people well that will have a continuing role in the business and will populate the board. Their personal backgrounds, temperaments, and the skills they bring are important considerations. Industry contacts, transaction experience, knowledge of public markets, and organization development expertise may be beneficial to the effort to maximize the future value of the business. Do not be satisfied with vague allusions to helping direct the corporate strategy. A precise understanding of the expected roles and the skills and experience that support those roles is a reasonable expectation.

How does the equity firm react to stress?

Business is business, which means everything doesn't always turn out as planned. When a portfolio company hits a significant rut in the road, how do the decision makers at the equity firm react? Do they provide rational support for decisions; are they reasoned and deliberate in assessing accountability; do they draw quick unsubstantiated conclusions; or do they attempt to micromanage the business ei-

ther directly or by turning up the demands for information and financial reporting? It is difficult to predict how human beings will react when the chips are down. The experience of former operating partners offers valuable insight into how a potential capital partner will handle adversity. So, seek out their advice.

What fees will your partner expect to extract from the business?

The economics of your investment can be impacted by significant transaction and management fees charged to the company. This often comes as a surprise to the operating partner because it is not readily understandable why the equity firm would be charging itself. In most cases, it is the fund managers that benefit from these fee arrangements rather than the equity fund itself. In essence, the manager is charging additional fees to its

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fund investors. However, minority shareholders, like you, will be footing part of the bill.

If a company is being sold in its entirety, many of these issues are unimportant, but if an owner plans to bring on a new partner while retaining an interest in the business, it pays to investigate the backgrounds, styles, and incentive systems of the people who may fill that role. The importance of a good philosophical and personality fit between shareholders, management, and the new capital partner cannot be overstated. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

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