FEATURE: Use of sponsor-style CLO retention vehicles to drop; managers weigh alternative risk retention approaches as investors increase allocations to CLO equity strategies.

The use of sponsor-style retention vehicles by UK-based CLO managers is set to drop as Brexit threatens the compliance of such structures under MiFID. With originator structures therefore gaining popularity - and managers investigating an 'alternative' approach to sponsor-style structures - an increasing number of investors have stated their intention to allocate funds to CLO equity, either through risk retention vehicles or via warehousing strategies.

"18 months to two years ago, nearly all London-based CLO managers were opting for the sponsor route," said Martin Sharkey, partner at Dentons. "But since a hard Brexit became a possibility or even a reality, third-party, originator-style risk retention structures have become more popular."

Originator-style retention vehicles, which have in many cases been set up by opportunistic credit managers, attract third-party capital to fund the 5% equity retention strip required under European structured finance risk retention laws. The vehicles act as originator and investor in a CLO's equity tranche - in some cases the credit manager's own CLO - and in other cases, those of other CLO managers.

Blackstone's publicly-listed GSO Loan Financing Limited was the first such 'originator' structure to be launched, back in 2014. Since then, a number of other originator vehicles have followed: Chenavari's Taurus Originator vehicle, for example, retained a 5% economic interest in the firm's latest transaction, **Toro CLO 3**. Napier Park's originator vehicle, NP Europe Loan Management I DAC, is meanwhile understood to be originating loans and holding the horizontal 5% equity strip in Rothschild's **Contego IV** CLO.

For some investors, the type of retention structure utilised by a CLO is of importance when making their investment choices. One investor noted that a structure with a large market acceptance allows the deal to be more liquid.

"I always ask: who is the ultimate risk holder: is it on balance sheet, is it held by a vehicle and how is it financed?" the investor said. "Then I ask how widely accepted the chosen retention option is - if it is a sponsor vehicle, does it have 'UK manager risk', or is it an originator from a European rules perspective?"

Other CLO investors are less concerned, noting that the retention vehicles involved in a deal - be they sponsor or originator - are "not a point of trading relevance".

Investors and managers alike are concerned, however, that UK sponsor retention vehicles will not meet certain regulatory requirements post Brexit and will become defunct: specifically, UK managers will not be MiFID-licensed and will need to take an alternative route in order to comply.

Originator vehicles have the benefit of being domiciled in Ireland, the Netherlands or Luxembourg in order to take advantage of such countries' double tax treaty networks.

"In and of itself Brexit should not impact originator structures because the issues thrown up by Brexit relate more to the ability of a UK manager to come within the regulatory requirements of the 'sponsor' definition, or the ability of a UK manager to act as the CLO manager of an EU vehicle through passporting," added Mr. Sharkey, adding that managers based outside London - in France or Ireland, for example - may still opt for the sponsor route, however, given that they will not be affected by Brexit.

In sponsor risk retention vehicles, the sponsor usually foots the cost of financing the retention strip: if the sponsor opts to hold a vertical slice, full recourse financing is often provided by a bank. Bank funding for a horizontal equity retention piece is generally not possible, however, as banks are less keen to fund that level of risk.

Cloning the CLO manager

An alternative approach is therefore being investigated by a number of managers: in the case of these ‘manager sponsor entities’, the sponsor sets up a new standalone CLO manager to hold the required 5% horizontal retention piece. The new entity will typically be seeded by the sponsor’s employees, and funded by third-party capital.

“These entities effectively ‘clone’ a legacy CLO manager,” said Christian Parker, partner at Paul Hastings. “In these cases the economic return generated by the retention investments feeds its way up to the fund, which solicits third-party money.”

He noted that the separation between the two entities has to be managed carefully and that inevitably there are a number of tax issues to deal with, as well as employment issues should a team member be transferred from the legacy manager to the new entity.

Mr. Parker also noted that Brexit is likely to cause problems for sponsor-led structures. "In order to be compliant as a sponsor you must be MiFID-authorised. "If you are not in the EU, you are unlikely to achieve MiFID authorisation", he said. "It is unclear whether managers will be able to substitute an originator into a structure as the prospective introduction of the Simple Transparent Securitisation (STS) regulation [currently still in draft form] in 2017 may also require originators to be EU-registered entities. This may cause further complications when it is introduced."

CVC Credit Partners is one such firm that has recently completed a ‘manager sponsor entity’ CLO retention structure, which encompasses both a US and European CLO manager and which is also risk-retention compliant in both jurisdictions. CVC Credit Partners European CLO Management will manage all future European CVC CLOs, hold a minimum of a 5% horizontal retention interest as a sponsor under the EU regulations, and hold an eligible horizontal residual interest as a sponsor under the US risk retention requirements. It is understood that this is the first vehicle of its kind to offer dual compliance in the US and Europe.

Ares is also understood to have a similar manager sponsor entity in the works, although this will be Europe-focused, rather than global, according to sources.

“A number of managers are watching and waiting with regard to their risk retention fund strategies,” said Mr. Parker. “There are lots of variables to contend with - not only is Trump threatening to rip up the Dodd Frank act, thereby nullifying risk retention requirements in the US, but Brexit means managers may need a contingency plan for 2019.”

He added: “That said, if a manager has ambitions to manage any number of CLOs in the future, that's a lot of retention investment that needs financing.”

Mr. Parker said his firm was aware of around 15 managers with varying degrees of appetite to take this sort of project forward. He also noted that while risk retention funding is currently focused on the CLO market, other ABS issuers may look to third-party financing for retention pieces in the near future.

“For example, smaller mortgage providers in Europe may not wish to hold 5% retention pieces for more than a couple of deals,” he said. “As a result they may look to third-party financing structures at some point."

CLO equity play

While managers decide on their preferred choice of retention strategy, it is clear that investor appetite for exposure to CLO equity is high. With total returns of 32%, European CLO equity was one of the best performing asset classes within European credit in 2016, according to JPMorgan Research.

Several funds have recently expressed their intent to allocate funds in this area. **Pearl Diver Capital**, for example, which invests across mezzanine and equity CLOs, recently told CapitalStructure that it is targeting CLO risk retention investments in its latest fund.

Volta Finance (managed by AXA IM) also expects to deploy more capital in CLO equity tranches and in bank balance sheet transactions, according to its latest monthly report, adding that it expects to utilise CLO warehouse exposure as a way to access CLO equity positions with better economics.

“The risk retention play in CLOs via CLO warehouses can be an interesting strategy for equity investors,” commented Oliver Fochler, managing partner and CEO of Stone Mountain Capital. “By investing in the CLO equity while the CLO is being structured, the investor can get a double-digit (20% per annum) upfront distribution within the first year when the CLO is ultimately sold.”

He added: “The structure is complementary to traditional private equity investments, which target back-loaded multiples of 2.5x to 3x.”

It is not unusual for CLO equity players to invest in the first-loss piece of the CLO warehouse, and then roll into the CLO equity. Investors also have the option to participate in the warehouse and then choose not to roll into the CLO.

However, according to a UK-based investor, CLO managers generally want $10m to $20m for warehouse first loss participation, meaning that it tends to be the larger firms that participate, rather than smaller entities.

Nevertheless, Mr. Fochler noted that there are a 'good number' of funds cropping up now that will acquire those first-loss pieces. "It's all a CLO equity play," he said. "[Investors] are buying unrated, chunky and illiquid positions for a long-play strategy."

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

This article was first published on CapitalStructure's website on 29th March, 2017.