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Managers scrutinise valuations as CLO reset and refi boom continues

CLO managers are putting a concerted effort into accurately valuing their deals as they seek to embrace the current reset and refinancing phenomenon.

One company that has benefited from this movement is Houlihan Lokey. The advisory firm further expanded its structured credit valuations business after hiring Jonathan Sloan in late 2013. Since then it has done work for a variety of investors looking to obtain marks for their CLO positions, but 2017 has seen an influx of CLO managers signing up to the firm's services.


Sloan: 'drawbacks exist'

Sloan, who started his career at Arthur Andersen and later worked in JP Morgan's CDO group between 1999 and 2002, says that CLO refis – while popular among certain managers and equity investors – have their drawbacks. Unlike refinancings of pre-2014 CLOs, which are protected from risk retention rules, refis that priced after 24 December 2014 are not subject to the Crescent no-action letter and are, therefore, deemed to be subject to risk retention.

"A post-2014 deal refi requires a manager to put up 5% risk retention capital and, while several managers were large investors in the equity of their own CLOs at the deal's inception, they are finding that this is still not sufficient," says New York-based Sloan.

He explains that a manager's 5% risk retention stake is subject to a fair value assessment. Therefore, even if at inception a manager is compliant with risk retention by holding 5% of its CLO through the equity tranche, this status is subject to change. "After two years when a CLO exits its non-call period, the value of the equity is significantly reduced compared to its original value. This is because a large amount of the cashflows have been paid out by this point," says Sloan.

In the last month, there have been a couple of cases of CLO managers issuing more equity as part of a reset. In one such example, when Bank of America Merrill Lynch reset LCM CLO XV on 11 May, this resulted in $16.5 million of additional equity being created. Tetragon Financial Group typically holds majority equity in LCM CLOs, but the firm had to add to its stake to ensure continued compliance with risk retention rules.