REFINITIV

Credit funds look to take advantage of great dislocation - IFR News

17-Apr-2020 12:43:25

To view this story on Eikon, click here

- Structured Finance
- The well-prepared and the opportunistic get ready to benefit from forced sales

April 17 (IFR) - After the 2008 financial crisis, credit funds paid pennies on the dollar for fixed-income securities trading at distressed levels – then made a fortune as the market recovered. Now, with global economies devastated by the coronavirus pandemic, credit funds want to raise billions in order to repeat the trick.

A case in point: PennantPark, a New York-based US$3.8bn alternative credit fund, is looking to raise up to US$1bn to invest in syndicated loans trading in the secondary market at bargain-basement prices.

"We are looking at potential bargains in the broadly syndicated loan space non-impacted by Covid-19," said Art Penn, PennantPark's managing partner and founder.

Penn says his fund, which before the coronacrisis primarily invested middle-market loans, has been buying syndicated loans at between 80 and 95 cents on the dollar and plans to keep doing so for several months ahead.

He is not alone. Dozens of firms are courting investors to put money into distressed-debt investment vehicles that will look to buy discounted assets from forced sellers.

Distressed buyers are operating in the middle of a selling frenzy from traditional funds whose investors are running for the hills, and amid the obvious pain among CLO underwriters and their clients trying to reduce risk. Loans with an estimated face value of US$43bn (for both CLOs and commercial property structures) were sitting in bank warehouses when the crisis hit.

Even intermediaries can make a fortune in such an environment. “Just like after 2008, structured products price distortions today are wide enough on the fluctuating bid/ask that a savvy third-party CLO broker ... could earn a US$1m commission on a single trade,” said a CLO trader.

Saba Capital Management, one of the top-performing long/short credit funds, is another ramping up efforts to profit from the turmoil, raising US$500m in the first quarter.

Its flagship closed-end fund was up 67% this year as of March 13. It is one of only a few credit funds set up to profit from so-called tail – or black swan – events. The Saba Capital Tail Fund posted annual gains of 174% and the Saba Capital Neutral Tail Fund 54% through March.

Boaz Weinstein, founder and chief investment officer of Saba Capital, which has US$2bn of assets under management, said that large banks' high-yield and CDS desks stepping back from taking risk was a key reason for his fund's most profitable year-to-date return since opening more than a decade ago.

Recent buying at Saba includes first-lien secured bonds and loans with a face value of US$80m. The first-lien credits recover an estimated 50% more than unsecured debt in bankruptcy. "That is the true opportunity," said Weinstein in a note to investors announcing its stellar returns.

Another highly active credit fund is Arena Investments, a US$1bn hedge fund that uses credit enhancement structuring techniques on loans as small as US$10m.

Daniel Zwirn, Arena’s founder and chief investment officer, said his fund's positioning came ahead of the pandemic. "The firm has spent the past three years preparing for a credit market correction, which put us in a strong position to play offence in this market," he said.

“I will be cleaning up the mess for next two decades.”

PAIN TO COME

The market should expect more fund redemptions and margin calls, especially from RMBS and CMBS funds, which are some of the most leveraged vehicles, said one head of credit trading at a top underwriter.

Zwirn agreed: "Some investment funds that used repo, total return swaps and other forms of recourse leverage at three to 10 times may not survive the first-half.”

Warehouse facilities at banks have assets that total a notional US$23bn in CLO vehicles and another US$12bn–$15bn in commercial real estate conduit deals plus US$5bn in commercial real estate CLOs, according to securitisation specialists. According to a report by trustee US Bank, 72 CLO warehouse lines were open in March. But CLO managers are reportedly managing to maintain warehouses, working with arrangers to avoid liquidations and explore options to ride the storm.

Perhaps the biggest challenge for the CLO sector and what has caused the flow of new CLOs to stop is the risk of "overcollateralisation test breaches causing lower mezzanine tranches to pay in kind, which is definitely going to happen from credit stress," said Laila Kollmorgen, a managing director in the leverage finance group at PineBridge Investments, which has US$103bn of assets under management.

With such breaches all-but assured, investment in lower-rated tranches is a very difficult sell. That said, the sharp upswing in price already seen since the lows in March highlight the upside potential built into these structures.

Kollerman said: "It's a matter of how many payments are missed – one or two – before CLOs can raise the value of the investment portfolio to redirect cashflow back to the managers and subordinate investors."

In the meantime, uncertainty of where and when a floor will be found in prices for the underlying assets in CLOs has forced managers to switch to static CLOs – aka “print and sprint” deals – and retain Double B, Single B, and equity tranches.

HEAVY TRADING

According to research from Bank of America, some 20% of speculative-grade CLOs are likely to be in breach of overcollateralisation tests, shutting off cashflows to equity noteholders at the next payment date, although CLO managers say that heavy loan trading during the volatility in March may help some deals to improve par value to pass collateral tests.

Some managers are buying formerly investment-grade companies with good cashflow in sectors less impacted by the pandemic in an effort to pass the tests.

"We're actively engaged in discussions with our managers encouraging them to focus on improving portfolios through trading during the volatility," said Daniel Wohlberg, a director at Eagle Point Credit, one of the largest CLO equity investors in the market.

TO THE RESCUE

All this distress is showing up most clearly in secondary prices. Lower mezzanine CLO bonds are trading at or below 50 cents on the dollar, depending on the duration and quality of the reference loans, said a portfolio manager at one of the largest CLO investors in the US.

The portfolio manager added that he considered it a win if he could sell high-quality Double B CLO paper at 50 cents.

The recent revision to the US Federal Reserve’s Term Asset-Backed Securities Loan Facility that makes new issue Triple A static CLO tranches eligible for purchase by the

Fed is certain to help support prices and should allow banks to move on some of their warehoused exposure.

“TALF will make it easier for participants in warehouse facilities to exit via the term market if they choose,” said one CLO specialist.

Those lining-up static CLOs this month include Palmer Square (a fittingly named US$200m CLO called Dislocation Financing via Jefferies) and PGIM (Dryden 48 via Barclays). The US$500m Ares 55 CLO via JP Morgan is set to become the first non-static CLO since the market closed last month. It has a three-year reinvestment period.

(Reporting by David Graubard
This story will appear in the April 18 issue of IFR Magazine)

12B1