



Delaying the inevitable?

Market braces itself for fallout from forced loan extensions

As the much-debated maturity cliff starts to loom larger on the horizon, focus is increasingly turning to CLO extension risk. While loan extensions might be beneficial in some cases, in others default – whether sooner or later – is beginning to look inevitable.

The slower the market recovery, the more loans will need to extend to have any chance of repaying. In cases where repayment is still likely, extensions are expected to be granted, with the loans then having a higher spread and longer life rather than being closed for what can be immediately recovered.

Michael Hampden-Turner, structured credit strategist at Citi, says one of the main issues is the uncertainty surrounding how strong a recovery there will be in the next couple of years. He explains: "To predict what will happen to this cliff, you have to think about what capital markets will be like in a few years' time. Will investors be looking for high yield? Will they be interested in loans? Will the LBOs be performing or not performing?"

He continues: "You have to take a view on the receptiveness of the market to buying new loans and also the general health of the economy. In a normal recovery, you would expect by that time for those things to be ok, but there is a high degree of uncertainty at the moment and the jury is still out on what will happen."

Conor Houlihan, partner at Dillon Eustace, agrees that uncertainty is an issue. He says the consensus is that the maturity cliff is manageable for the next two or three years, but far less certain beyond that.

Asset quality tests, such as weighted average life, may constrain the reinvestment period, which in any case may have expired by then. Houlihan also notes that CLOs that have experienced downgrades may be unable to extend or refinance underlying collateral.

This is exacerbated by the almost-total lack of new CLO issuance and the de-leveraging going on at banks. However, Houlihan believes there are still positive possibilities.

He says: "This is where there appears to be an opportunity for non-traditional investors with a more flexible mandate to provide new loan capacity. Some of the newer hybrid structures [incorporating elements of SPV/CLO-type vehicles and/or investment funds] may not have the same issues in terms of limitations on their ability to reinvest or invest beyond a particular period of time."

Another important issue with extensions is that managers and triple-A bondholders have opposite motivations. Hampden-Turner explains: "The triple-A bondholder wants to be paid down faster because that means they get a higher yield, but the equity guys will be happy to see it run on because then they get more money for longer."

He continues: "These opposite motivations were always well known and so therefore different CLOs have different covenants to stop this from happening, but what was not anticipated was a large number of forced extensions where managers are not allowed to sell positions or buy new ones in a static CLO. There is investor concern about that and there is interest in what might happen."

Quite how many loans will extend is hard to predict, especially as the last few years have been very unusual and therefore difficult to project from. Hampden-Turner believes a base case of 50% looking to extend is reasonable. The central consideration in each case will be whether it is worth holding an asset if you are receiving less from it than the cost of funding or whether it is better to sell at a loss in order to free up capital.

He says: "Most people seem to be in an all-or-nothing frame of mind. Either they will get rid of their holdings and take a loss to free the capital or they will sit it out, wait an extra year or two and, if it extends a year or two, that is not the end of the world. The risk is that, if one or two institutions start selling, that puts pressure on prices and others start thinking maybe they should sell before the market dries up."

Selling might be seen as a knee-jerk reaction, but Houlihan warns that extensions are not always preferable. He says: "For a CLO vehicle that can and does participate in such an extension, obviously this results in additional income and perhaps improved terms for its collateral. Clearly, however, managers need to be mindful of the economic rationale behind any proposed loan extension – for example, if some of the additional income is applied to pay the lower tranches and, notwithstanding the refinancing/extension, the underlying loan subsequently defaults, there could be an adverse impact on the more senior classes of noteholder."

The problem with extensions is that they do not eliminate the risk of default, with some deals in such trouble that an extension would only serve as a stay of execution. Hampden-Turner notes: "Extensions delay the inevitable in many cases. There are many cases where distressed companies should never have borrowed the money in the first place. But for some, if the extension does allow the economy time to recover, then it does increase the probability of either being bought out or starting to turn a profit."

Houlihan agrees that extensions may do nothing more than delay defaults in some cases, largely dependent on the underlying credit. He concludes: "At some point, they need to find a way to pay down the principal; otherwise, there will be defaults both at the loan level and potentially at the CLO level. From that point of view, the availability of other sources of funding (non-traditional sources, in particular) as alternatives to amend-and-extends could become key to CLO vehicles avoiding defaults in the future."

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