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In Practice

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Private portfolio financings on the rise

In this article the authors consider the benefits of private portfolio financings in light of challenging conditions for CLO issuance.

Financial markets participants are constantly looking towards innovation as a way of developing the next product, driven by efficiency and profitability. Macroeconomic and geopolitical conditions also have an impact – for example, the Global Financial Crisis (GFC) resulted in a significant increase in regulatory oversight. Such events act as catalysts for the subtle changes that are underway regardless. Private portfolio financings emerged some time ago as a tool for asset managers and funds to finance their portfolios privately through bespoke, tailor-made structures, often with a single bank provider, and without having to rely on third-party equity. More recently (thanks also to the European securitisation regime which was implemented in the aftermath of the GFC), European banks have been able to offer these financings with competitive pricing (given the favourable capital treatment available for such transactions), which in turn opened up a new business origination platform for them. Lending to private debt funds in particular has increased sustainedly, despite the debt fund facing the administrative burden of compliance with the securitisation regulations. Private portfolio financings have also been in demand in the US, after national funds became comfortable with the regulatory compliance required for transactions involving a European bank.

CHALLENGING MARKET CONDITIONS FOR CLOs

For market participants using collateralised loan obligations (CLOs), recent market volatility has been tricky. During 2022-23, issuance has been down relative to prior years. Although CLO managers buy the equity in their transactions, triple-A and other investors have been hesitant or unwilling to commit at pricing levels which work for a manager's arbitrage. While banks have been stepping in to buy a portion of the senior tranches in certain transactions, assets have been hard to come by due to a shallow primary loan market. Corporate borrowers have been seen to amend and extend their financing arrangements rather than refinance. Pricing in the secondary loan market has also been unreliable. As a result, CLO warehouse facilities that were implemented prior to 2022 or shortly thereafter have come under pressure; while they can facilitate a CLO take-out, they are not designed or intended to offer a long-term line of leverage and, due to the global rise in interest rates, any warehouse term extension attracts a significant additional liability cost. These conditions have made CLO issuance a challenge both from a bank and a manager perspective, leading market participants to consider innovation with increased urgency. Private portfolio financings have been particularly helpful to bridge the gap in issuance. We have seen the emergence of a borrowing-base portfolio financing akin to a warehousing line, but running for a longer term, requiring less pressure to ramp up, and offering more flexibility to the involved parties.

BENEFITS OF PRIVATE PORTFOLIO FINANCINGS

- **Lenders:** Banks have been interested in maintaining and developing new relationships with CLO managers and credit funds – now especially in anticipation of the public markets becoming active again and the expected surge of CLO activity, including the inevitable resets and refinancings which will shortly become due. In the meantime, private portfolio financings pose a low risk for the senior lender since the structuring features are tailored to their own requirements. As ratings are not strictly necessary for these financings, portfolio composition and asset quality requirements enable the manager and bank to agree on concentration limits with reference only to the bank's internal credit satisfaction and subject to typical overcollateralisation and market value tests as protection. Banks may also use this product as an incentive to attract new managers. In the lead-up to 2022, a large number of first-time managers entered the booming European CLO market, only to find themselves unable to locate a consistent stream of assets to ramp up their portfolio or attract banks to fund it on an extended basis. In addition, private portfolio financings allow lenders to keep their origination business ticking along as they earn an interest return and potentially other fees, such as an early termination fee.
- **Managers:** Managers can execute a deal on which they may earn fees and create leverage (potentially even tranched to investors' credit appetite) to build a portfolio at their own pace, in line with their own style, and without the pressure to execute a public takeout. Effectively, they undertake a managed deal with the help of a warehousing line that they can draw on whenever an attractive opportunity presents itself to buy an asset, as opposed to a public CLO in which all liabilities accrue spread from the closing date when the portfolio is not yet fully ramped up. This structure enables an established manager to "test" a bank relationship before appointing them to act as arranger for their public deal, while a new entrant manager can build their reputation before attempting a full capital markets issuance.
- **Third-party investors:** As said above, private portfolio financings are often private arrangements involving only one senior lender. Nevertheless, third-party investors may come in to deploy capital in the form of equity or mezzanine investment set to their risk appetite, while benefiting from a manager's credit selection expertise and a continuing exposure to the credit market. This type of deal can be interesting for investors, as they can push for bespoke terms and greater flexibility on portfolio composition than they would be able to achieve on public CLOs, all without incurring the large costs of a public CLO. Other investor motivation includes building CLO relationships for the future or simply diversifying their investment portfolio by deploying capital into a managed and leveraged debt portfolio.

CONCLUSION

Private portfolio financings have clearly become a distinct product across finance markets, The demand for them continues to grow and it will be interesting to see if their appeal stalls once market conditions, particularly those affecting the CLO space, return to normal. ■