Guest Editor's Letter

Jeffrey Stern

Jeffrey Stern
is a partner and co-chair of the structured finance practice at Winston & Strawn LLP in New York, NY.
jstern@winston.com

This past September, I moderated a panel at the ABS East conference in Miami entitled "*The New Esoteric: Exploring the Potential for New Asset Classes Using Securitization as a Tool*," and the discussions among the panel members—a lively and insightful group—have stuck with me with surprising persistence. During the course of those discussions, the panelists were able to identify and articulate some commonalities or "themes" within the evolving use of structured finance for new asset classes—themes that have been percolating in my thoughts ever since. Because I have the privilege (and have carried the stresses) of guest editing this Fall 2019 edition of *The Journal of Structured Finance*, and because at least one of these thematic elements has direct bearing on some recent trends in the collateralized loan obligation (CLO) markets (and some future trends, I hereby predict), I need not harbor these thoughts alone, but have a forum to share them, in this Guest Editor's Letter.

CLOs (and their cousins, collateralized bond obligations) themselves began their lives—as most veterans of the CLO market are well aware—as an esoteric class, hunting for pockets of illiquidity, and funding those illiquid pools (in large part) by issuing highly rated capital market notes, thereby extracting, and transferring to equity investors, the illiquidity premium and rich pricing trapped in those under-developed markets. That essential thrust of CLO economics has significantly modulated over the years for the most prominent segment of CLOs—CLOs backed by broadly syndicated loans—which today fund loans that are readily tradable and competitively priced. Consistent with this shift (and with the relatively low barrier to entry for new broadly syndicated loan [BSL] CLO managers), the BSL CLO market, while continuing to be extremely active and vibrant, has experienced compressed fees and reduced returns.

CLOs have, nonetheless, continued to explore (and profit from) less-well-trod paths and more challenging markets. Middle market CLOs, which have of late experienced significant growth and increasing range, offer one such example. As discussed in greater detail in the terrific article in this edition by Michael Mullins and Russell Casper, both of Winston & Strawn, the loans underlying middle market CLOs are much less liquid—sometimes entirely illiquid—and must be managed in a manner more similar to the management of an operating asset than the trading of a CUSIP number, and often for the full life of the loans. This type of CLO requires its manager to have a skill set that extends well beyond credit analysis, as such managers are called to both incubate the growth and stability of portfolio companies, and to manage the company—often with dedicated workout teams—through difficult downturns.

Another such example of more "esoteric" CLOs may be found in the emergence, in recent years, of a new post-crisis form of commercial real estate (CRE) CLO. The mortgage loans that collateralize CRE CLOs are a far cry from plain-vanilla broadly syndicated loans: As discussed in the very informative article on CRE CLOs contained in this issue, written by Dennis Kelly and Christine Spletzer, both of Winston & Strawn, the mortgages backing CRE CLOs are typically secured by transitional real properties without stable cash flows, and often have significant future funding obligations by the lender. Perhaps more striking still, the properties underlying the loans may require ongoing construction, may require negotiation of leases with existing tenants (or developing new tenants), and may call for other material additional capital expenditures. These loans are truly operating assets, with construction and operating risk, leasing/re-leasing risk, and material ongoing funding and capital investment, all of which require highly specialized real estate skills, in addition to traditional credit skills. As noted in the Kelly–Spletzer article, this is not a product for the uninitiated or faint of heart, and those barriers to entry provide both challenges and opportunities to participants in that market.

These last two categories of CLOs reflect a trend that goes to one of the key themes mentioned previously: the increasing incentive, in today's highly liquid capital markets, to identify, and extend structured finance (and, here, CLO) techniques to, asset classes that both have scale and are underfunded, in part because those assets demand—in addition to necessary credit expertise—highly specialized (and hard-to-assemble) skill sets. Many of these new asset classes involve portfolios that require deft management of operating and/or completion risk—not a risk commonly found or permitted in structured finance transactions—which gives them an aspect of a hybrid transaction, combining structured finance and non-structured finance elements.

This emerging phenomenon of hybrid transactions, that use CLO technology to finance idiosyncratic and high-touch assets, seems destined to become an important element in our ever-transforming US CLO markets. The extraordinary liquidity that the capital markets have experienced over the last nearly twenty years (with a notable hiatus during the Great Recession) continues to press participants into an ongoing search for value and yield. Those forces will, perhaps inevitably, draw CLO practitioners into specialized, high-barrier markets, in which they can mine embedded and hard-to-access value. One such hybrid category that is on the cusp of launching—or so the panelists from my "esoterics" panel insisted—is aircraft loan CLOs. Something to look forward to…

Finally, in addition to the articles cited above, this edition of *The Journal of Structured Finance* boasts a roster of engaging, thoughtful, and highly informative articles, covering a wide range of topics, by some of the leading lights of the CLO industry.

- Richard Reilly, of DLA Piper LLP (US), offers a robust and in-depth analysis of recent developments affecting the structuring of capitalized manager vehicles.
- Philip Paschalides, James Burch, Shamar Ennis, Kristi Green, and Christopher Dibben, of Walkers, provide terrific insights into the use of various features of Cayman Islands corporate law to facilitate innovative structuring of CLO warehouses.
- Andriana Loukanari and Christian Berardo, of Citibank Agency & Trust, discuss the phasing out of LIBOR (and selection of its replacement) and offer a clear and helpful overview of the EU Securitization Regulation.
- Batur Bicer, Ryan Brauchler, and Serhan Secmen, of Napier Park Global Capital and Maggie Wang of Citibank present a fascinating study of factors that may drive CLO equity returns and those that aid in identifying a good CLO manager.
- Elliot Ganz shares the potentially important (and alarming!) implications of recent litigation that raises questions concerning whether institutional term loans are securities for purposes of US securities laws, and delves into the substance of the new Japanese risk retention rules and their import for the CLO markets.
- Kevin Kendra examines in rich detail the macroeconomic factors that have shaped and continue to influence the evolution and growth of the CLO and US leveraged loan markets.

Enjoy!