<u>Bloomberg Q&A: Eagle Point Sees Loan Volatility Coaxing New CLO Investors</u>
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Thomas Majewski, managing partner and founder of Eagle Point Credit Management, says volatility in loans late last year presents buying opportunities for new and existing CLO investors. He expects $100 billion of new sales of the securities this year. Majewski, who helps manage Eagle Point's $2.6 billion of assets, spoke with Sally Bakewell on Jan. 8. Comments have been edited and condensed.

What's your outlook for the CLO market this year?

We remain constructive. Some of the mark-to-market volatility in the fourth quarter was driven by technical factors in the loan market, principally outflows from retail mutual funds. That pushed the prices of loans down. But interestingly, the bulk of the draw-down was on the higher-priced, higher-quality assets, not the lower-priced or high-risk assets. So we had an unusual dynamic where the loan market lost several points, without meaningful credit expense, and that helped push the prices of many CLO securities down.

Looking forward to 2019, we believe many investors view this as an opportunity. Of course there's always risk, but prices are more attractive than they've been for some time. Our issuance estimates are around $100 billion of new issue CLOs, about $70 billion of resets and $40 billion of refinancings. Good quality loans trading in the mid-to-high 90s is a very good scenario for CLOs.

Which part of the CLO offers the most value now?

We continue to be active in both BB and equity investing. We manage a number of vehicles focused on CLO equity, and we invest in both the primary and secondary markets.

Returns up and down the capital structure of a CLO are at 52-week wides. Today, AAAs often are over a 4 percent return on a current yield basis in a floating rate security, which is very attractive. That's probably somewhere between 75 basis points wider than they were at the beginning of the year. Similarly, at the BB level, it's frankly quite possible to create opportunities with double-digit yields.

Where are points of weakness in the market?

One of the biggest challenges facing the loan and CLO market is increasing weakness in loan documentation. There are two categories of document weakness: there's ongoing maintenance covenants, which are just a reality of the market today. And then there are other provisions in many loans, such as builder baskets or most favored nation status, or the ability to trapdoor an asset.

These features had been increasing throughout 2018. However, the price volatility at the end of the year has stemmed that tide at least for the moment. More recently, loans have gone up, between one and three points depending on the loan. We've seen a slowdown in retail outflows and increased buying from CLO investors.

How is the investor base in CLOs changing?

In the BB area, we continue to see increasing participation from insurance companies. They previously focused on investment-grade securities but an increasing number are now using CLO BBs as a high-yield bond replacement strategy.

Within CLO equity, we're seeing increased demand from endowments and foundations. A number are beginning to make their first allocations into CLOs as we speak, which is a big event in the market. And then most of the large corporate pension consultants, at a minimum, have studied the market quite carefully and quite a few of them are recommending participating to their pension funds. Many are viewing the recent price movement as the catalyst from we've been looking at this, to, let's use this as a great entry point.

What's the biggest misconception about CLOs?

That CLOs are forced sellers. A typical CLO has the wherewithal to hold an asset to the optimal recovery. There's not a requirement to sell any loan based on rating or price. There are haircuts on OC (over-collateralization) tests, and it could cause cash flow diversion, so if there were an excessive amount of CCCs, that wouldn't be good news.