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Warehouse Financing—Ramp-Up Funding for CLOs

Historically, the manager of a collateralized loan obligation ("CLO") transaction often arranged a credit facility with a bank (most likely the underwriter for the intended new-issue CLO) in order to provide short-term financing for the acquisition (or "warehousing") of corporate loans before the launch of the CLO. Securing a warehouse facility remains a popular means for the manager to ramp-up the portfolio prior to launching a CLO transaction, and affords the manager more options in the timing and speed of the ramp-up process. Managers should be acquainted with the warehousing options potentially available and the sources of such financing.

SUMMARY

- While not as common in the current market, traditional warehouse facilities offer managers tools to aggregate CLO eligible loans over a set period of time.
- Alternative financing methods and sources continue to evolve, including those that mitigate potential market value risk through par-based structures.

General Framework

A warehouse facility is a relatively straightforward credit facility:

- The warehouse facility may have several classes of loans with differing seniority levels, with the subordinated or "equity" class typically funded by the manager.
- The borrower is often the special purpose entity that will later issue securities in the CLO transaction.
- The borrower pledges the corporate loans purchased as security for the benefit of the warehouse lenders.

The warehouse credit agreement typically has loan eligibility criteria that are similar to those that are expected to be included in the indenture. Ineligible loans cannot be financed using the warehouse line, and the warehouse agreement will have liquidation provisions permitting the warehouse lender to direct the sale of any loans that were or become ineligible.

Market Value Risk

One of the most significant risks to a manager in its role as the holder of the subordinated class of a warehouse facility is the market value fluctuation of the loans acquired. In order to mitigate this risk, a typical warehouse lender often requires that the manager (as the subordinate noteholder) maintain a certain level of loan-to-value ratio. As a result, if the market value of loans decreases, the manager may need to provide additional funding to maintain the warehouse lender's loan-to-value ratio.

Margin maintenance requirements continue to create potential for losses to CLO managers financing the ramp-up through a traditional warehouse facility. During the credit crisis, these requirements caused significant negative impacts on many market participants. In addition to forcing the manager to

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increase its investment in the subordinate class, the manager may otherwise adjust the portfolio in ways that may not be optimal to the timely completion of the CLO transaction. For example, the manager may elect to make changes to the portfolio (such as selling assets or seeking to acquire additional assets in order to achieve a more favorable loan-to-value ratio), which may extend the time necessary to reach an appropriate portfolio to launch the CLO transaction.

Innovation Continues

Recently, some CLO managers have successfully launched new-issue CLOs without relying on a warehouse facility. These transactions demonstrate that a warehouse facility is not a "must have" to launch a new CLO. The utility of having a well-structured warehouse facility, however, continues to be relevant for managers that seek more options to manage the ramp-up process and provide a hedge against challenging market conditions. A warehouse facility may afford the manager more time to select loans for the portfolio, will spread some of the risk during the ramp-up period to other parties, and may permit the more rapid acquisition of assets based on ready availability of capital. The cost of a warehouse facility will reduce the overall economics of the CLO transaction as it adds an incremental interest cost during the ramp-up. Managers should carefully consider the trade offs in cost and how to best mitigate exposure to market volatility in determining whether to seek warehouse financing.

Some banks have begun to innovate how warehouse facilities are structured, creating new types of facilities that may reduce the market value exposure born by the manager. Using cash flow techniques similar to those embedded in CLO transactions, such as overcollateralization ratio tests, new "par-based" warehousing structures may offer managers a financing tool better aligned with their overall capitalization and business structures. Features of these evolving structures include:

- Interest and principal proceeds are distributed in accordance with separate priorities of payment.
- The manager may sell assets out of the warehouse subject to set limits.
- Overcollateralization ratio tests are used to maintain the aggregate par amount of the warehouse portfolio, rather than a market value based test.
- Liquidation of the warehoused assets is permitted in certain limited instances.
- Delayed draw or variable funding notes may be used to help mitigate the negative carry created by upfront funding of a warehouse facility.

Managers should be aware of these emerging financing alternatives and consider the optimum financing approach to the ramp-up phase of new issue CLO transactions.

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