EDISON

Marble Point Loan Financing

Initiation of coverage

Disciplined leveraged loan investment specialist

Investment companies

Marble Point Loan Financing (MPLF) is a specialist closed-end fund that invests in leveraged loans directly and indirectly via collateralised loan obligations (CLOs) and loan accumulation facilities (LAFs) managed by Marble Point Credit Management (Marble Point). The experienced credit investment team employs a conservative, disciplined approach, seeking to achieve a low- to mid-teens percentage return on equity (ROE) over the long term. Performance has been mixed since MPLF's initial public offering (IPO) in February 2018, with its mark-to-market pricing approach directly reflecting recent market volatility. However, its underlying portfolio has been largely unaffected and cash flow generation remains strong, allowing the manager to take advantage of attractive investment opportunities.

3 months ending	Share price (%)	NAV (%)	S&P Lev Loan (%)	Credit Suisse Lev Loan (%)	Credit Suisse HY Value (%)	S&P 500 (%)
30/04/18*	1.5	0.3	0.9	1.1	0.9	(0.2)
31/07/18	1.9	(1.1)	1.0	1.1	1.6	6.9
31/10/18	2.0	1.3	1.1	1.1	(0.5)	(3.3)
31/01/19	(17.7)	(6.0)	(1.0)	(0.9)	1.2	0.3

Source: Refinitiv, Bloomberg. Note: *Eleven-week period from inception on 13 February 2018. All % on a total return basis in US dollars.

Investment strategy: Disciplined and risk-focused

Marble Point takes a conservative, disciplined approach to investment in leveraged loans, and acts with strong conviction (founded on detailed analysis). The manager seeks to invest with a meaningful margin of safety, based on an assessment of a credit's loan-to-value ratio, and to build or preserve the portfolio's par value through relative value analysis and active management (aiming to buy loans at a discount with an identified catalyst for re-rating). MPLF obtains its exposure through its subsidiary MPLF Funding (which invests in loans directly) alongside holdings in Marble Point CLO equity and debt securities and Marble Point LAFs.

Market outlook: Opportunities for CLO investors

The US leveraged loan market suffered from over US$20bn of retail loan fund net outflows in Q418. Loan spreads widened in November, with a commensurate effect on CLO equity market prices, and the broad sell-off in December marked the worst month for loan price declines in over seven years. While negative for mutual funds, which may be forced sellers due to redemptions, loan market volatility can create attractive investment opportunities for CLO managers, who can improve long-term cash flow prospects by buying loans at lower prices or with wider spreads, as CLO financing is locked in. US CLO new issuance reached a record US$128.9bn in 2018, with 37 CLO issues in November and December, amounting to c US$18.8bn.

Valuation: Shares now at a discount; attractive yield

MPLF's shares traded at a premium to NAV from its IPO until end-January 2019, and the current 4.9% discount compares with an average 5.7% premium since its launch. MPLF's 9.8% dividend yield is slightly higher than the peer group average, and its targeted increase in payout from 8% to 10% would lift its yield to c 12%.

1 March 2019

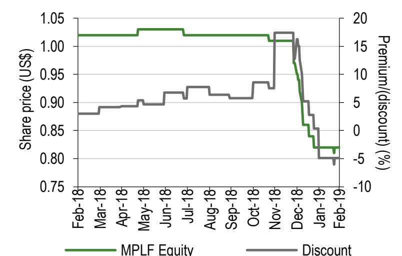
Price	**US$0.82**
Market cap	**US$169m**
NAV*	**US$177m**

NAV per share*	US$0.8621
Discount to NAV	4.9%

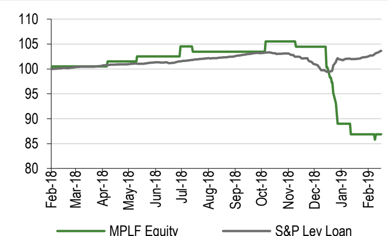
*As at 31 January 2019.

Annualised current yield	9.8%
Ordinary shares in issue	205.7m
Code	MPLF
Primary exchange	LSE Specialist Fund Segment
AIC sector	Sector Specialist: Debt
Benchmark	None

Share price/discount performance



Performance vs index



52-week high/low	US$1.03	US$0.81
NAV* high/low	US$0.9900	US$0.8172

*Including income.

Gearing

Gross*	16.6%
Net*	15.7%

*As at 31 January 2019. Excluding MPLF Funding debt.

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Edison profile page

Marble Point Loan Financing is a research client of Edison Investment Research Limited

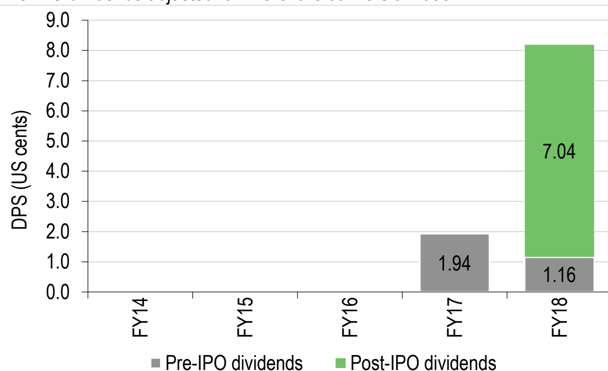
Exhibit 1: Company at a glance

Investment objective and fund background	Recent developments
MPLF's investment objective is to generate stable current income and to grow net asset value by earning a return on equity in excess of the amount distributed as dividends, through exposure to a diversified portfolio of US dollar denominated, broadly syndicated, floating rate senior secured corporate loans. MPLF has no official benchmark but performance is compared with US leveraged loan and high-yield bond indices.	■ 10 January 2019: US$0.02 per share Q418 dividend announced. ■ 13 December 2018: MPLF committed to invest US$26.2m (77.8% of the CLO equity) in Marble Point CLO XIV, a new issue US$400m CLO. ■ 21 November 2018: Q318 results – NAV TR +2.11% vs. CSLLI +1.93% and ICE BAML HYI +2.44%; share price TR +0.95%. ■ 16 November 2018: MPLF, together with MPLF Funding I, closed an issuance of US$29.5m of 7.50% senior unsecured notes due 2025.

Forthcoming		Capital structure		Fund details	
AGM	December 2019	Ongoing charges	1.05% estimated (page 13)	Group	Marble Point Credit Management
Final results	March 2019	Net gearing	15.7%	CEO & CIO	Tom Shandell
Year end	31 December	Annual mgmt fee	0.4% of gross assets (page 12)	Address	1st & 2nd Floors, Elizabeth House, Les Ruettes Brayes, St Peter Port, Guernsey GY1 1EW
Dividend paid	April, July, October, January	Performance fee	None		
Launch date	13 February 2018	Company life	Indefinite (subject to vote)	Phone	+44 (0)20 7259 1500
Continuation vote	2022 AGM	Senior unsecured debt	US$29.5m principal due 2025	Website	www.mplflimited.com

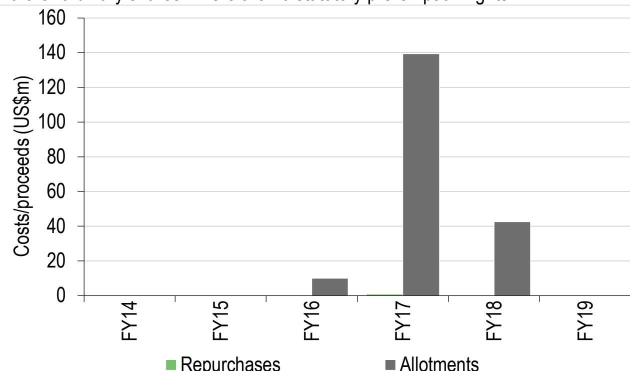
Dividend policy and history (financial years)

Dividends are paid quarterly, with an initial targeted dividend yield of 8% per annum, based on the IPO price of US$1.00. Inaugural dividend paid in Q417. Pre-IPO dividends adjusted for IPO share conversion ratio.

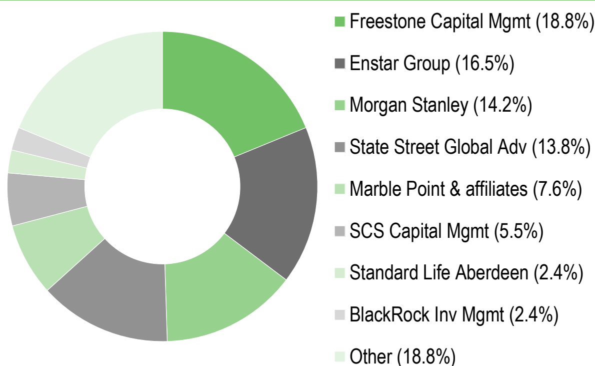


Share allotment and repurchase history (financial years)

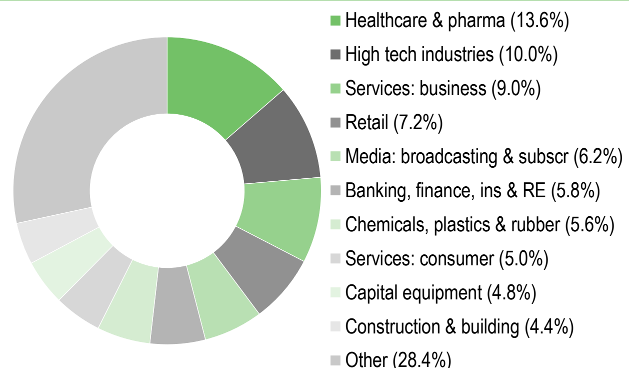
In February 2018, MPLF raised US$42.5m in gross proceeds in its IPO, through issuing 42.5m shares at US$1.00. The directors have authority to allot unlimited further ordinary shares. There are no statutory pre-emption rights.



Shareholder base (as at 28 February 2018)



Portfolio exposure by industry (as at 31 January 2019)



Top 10 underlying issuers (as at 31 January 2019)

		Portfolio weight %	
Company	**Industry**	**31 January 2019**	**28 February 2018***
Asurion	Services: consumer	1.1	1.0
SunSource Holdings	Capital equipment	1.1	N/A
Amneal Pharmaceuticals	Healthcare & pharmaceuticals	1.0	N/A
Numericable	Media: broadcasting & subscription	1.0	1.0
Albertsons	Beverage, food & tobacco	1.0	N/A
Alvogen Pharmaceuticals	Healthcare & pharmaceuticals	0.9	1.0
Kindred Healthcare	Healthcare & pharmaceuticals	0.9	N/A
Hemisphere Media Group	Media: broadcasting & subscription	0.9	N/A
Advantage Sales & Marketing	Services: business	0.9	1.0
Global Tel Link	Telecommunications	0.9	0.9
Top 10 (% of holdings)		**9.7**	**9.5**

Source: Marble Point Loan Financing, Edison Investment Research, Bloomberg, Morningstar, Refinitiv. Note: *N/A where not in end-February 2018 top 10.

Why invest in leveraged loans and CLOs?

Leveraged loans are loans issued by companies with relatively high levels of debt, which have lower credit ratings and offer higher yields than more secure, investment grade debt. The primary appeal of leveraged loans to investors is the relatively high, usually floating rate, interest that they pay. Although yields are higher to compensate for the greater risk of default associated with more highly geared companies, leveraged loans are secured on the assets of the company and usually rank at the top of the capital structure (senior secured loans), which has led to relatively high recovery rates being achieved historically in default events, in comparison with high yield bonds, which are generally unsecured. The Credit Suisse Leveraged Loan Index (CSLLI) has recorded a 5.5% annualised return over its 27-year history (1992–2018), with positive returns in 25 of the 27 calendar years (see **Appendix: Introduction to leveraged loans and CLOs**).

A CLO is a portfolio of leveraged loans that is securitised and managed as a fund, offering investors a series of interest-paying bonds (CLO debt) and a smaller equity investment class (CLO equity), which makes up the majority of MPLF's investment portfolio. CLO debt securities are lower-risk floating rate investments with a strong credit rating, which offer a higher yield relative to equivalently rated non-CLO debt securities. CLO equities are higher-risk, higher-return investments that effectively arbitrage the higher yield on the leveraged loan portfolio with the CLO's lower-cost, primarily investment-grade, debt financing. Although CLO equities bear the first risk of default in the loan portfolio, they also offer investors potential upside from periods of loan price volatility, when CLO managers can often take advantage of a CLO's fixed-term financing to purchase loans at a significant discount to their par value.

Based on a 2.75% US dollar Libor rate, a typical leveraged loan portfolio would yield c 6.5%, while a CLO equity could achieve a net annualised return of 10–15% (see page 16). The highly leveraged CLO structure (typically c 9:1 debt to equity) increases investment risk, but this is partly mitigated by long-dated financing and the control exerted by the majority CLO equity holder (see page 18). CLOs are also actively managed and incorporate structural protections that further mitigate risk.

In the very short term, CLO equity valuations tend to react positively to spread tightening and negatively to spread widening, similar to most other credit instruments. However, medium-term loan spread widening provides the opportunity for the CLO manager to reinvest in higher-return loans, thereby increasing loan portfolio cash flows while financing costs remain fixed, and thus improve the valuation of CLO equities, making them relatively unique in the credit universe.

Fund profile: Leveraged loan specialist

MPLF is a closed-ended investment company that was incorporated in Guernsey on 13 April 2016 and commenced operations on 2 August 2016, with its ordinary shares admitted to trading on the Specialist Fund Segment of the Main Market of the London Stock Exchange on 13 February 2018. MPLF's investment objective is to generate stable high current income and capital appreciation by earning a return on equity in excess of the amount distributed as dividends. MPLF targets an annualised total return in the low-to-mid teens over the long term, including an initial quarterly dividend of 2.0% of the US$1.00 per share issue price (increasing to 2.5% per quarter in the second year following initial admission).

MPLF seeks to achieve its objective by investing in a diversified portfolio of US dollar-denominated, broadly syndicated floating rate senior secured corporate loans. Direct and indirect exposure to loans is primarily gained via MPLF's wholly owned subsidiary MPLF Funding, together with investments in loan accumulation facilities (LAFs) and the equity and junior debt tranches of collateralised loan obligations (CLOs) that are all managed by Marble Point Credit Management

(Marble Point) and its affiliates (see page 8). As well as managing a number of CLO and LAF investment vehicles, Marble Point serves as investment manager for MPLF and MPLF Funding.

Marble Point is a specialist asset manager (registered with the US Securities and Exchange Commission – SEC) that focuses exclusively on leveraged loans, with c US$4.0bn in assets under management as at 31 December 2018. Marble Point was formed in 2016 by Tom Shandell, who has over 30 years' credit market experience, in partnership with Eagle Point Credit Management (Eagle Point), one of the world's largest CLO equity investors, with US$2.4bn in assets under management as at end-December 2018. Led by Tom Shandell and Corey Geis, Marble Point's investment team includes five industry-specialist credit analysts, with more than 17 years' average credit market experience across the team.

IPO background

In Q117, a portfolio of indirect CLO investments was contributed to MPLF in exchange for shares of common stock. This portfolio included investments in the equity tranches of seven CLOs acquired by MPLF's shareholders on 30 December 2016 in connection with the investment manager's acquisition of the CLO management platform of American Capital, a US-based business development company. Each of these CLOs is now managed by Marble Point.

MPLF was a private unlisted investment vehicle with its investments managed by Marble Point for the whole of 2017. Over the year, MPLF increased its net assets from US$10.2m to US$165.1m and NAV per share increased by 20.39% (rising from US$1.03 to US$1.24).

On 9 February 2018, MPLF raised US$42.5m in gross proceeds in its IPO, through issuing 42.5m ordinary shares at US$1.00 per share. All MPLF's pre-existing founder and co-investor shares were converted (at a ratio of c 1:1.23) into 163.2m ordinary shares immediately prior to admission, and no other share classes exist. On 13 February 2018, all of MPLF's 205.7m ordinary shares were admitted to trading on the Specialist Fund Segment of the London Stock Exchange.

Recent developments

In September 2018, MP CLO VII was reset, entailing the extension of its reinvestment period by one-and-a-half years to October 2020, and revision of its collateral quality tests, which greatly enhanced its ability to reinvest loan sale and repayment proceeds. MP CLO VII (initially issued in 2015) had experienced a decline in its equity value due to accumulating a significant amount of cash that was not invested in leveraged loans, as reinvestment possibilities were limited by its very short weighted average life test (see page 19). The high level of cash led the market to place a lower value on the CLO equity.

In November 2018, MPLF issued US$29.5m of 7.50% senior unsecured notes due in 2025 in a private placement, with net proceeds of US$28.4m. This capital was raised to enable MPLF to make further investments and thereby broaden the vintage period diversification in its CLO portfolio. The manager also expects the raising to be accretive to net interest income per share, while the seven-year maturity of the notes was important as it enables MPLF to continue to seek attractive risk-adjusted returns over a long-term investment horizon.

In December 2018, the issue of Marble Point CLO XIV was closed. This was a new issue US$400m CLO with an estimated effective yield of 12.4%, in which MPLF committed to invest US$26.2m, directly and indirectly via its ownership interest in the CLO manager, to acquire 77.8% of the CLO equity. Marble Point CLO XIV has a five-year reinvestment period, two-year non-call period and 13-year maturity. Its expected weighted average cost of debt is 195bp above Libor (Libor+195bp).

The fund manager: Marble Point Credit Management

The manager's view: Opportunity in leveraged loan volatility

With regard to the leveraged loan market volatility during the fourth quarter of 2018, Marble Point CEO Tom Shandell observes that S&P and Credit Suisse leveraged loan indices data showed a 1.75 point decline in the average par-weighted price (loan price relative to a par value of 100) from end-September 2018 to end-November 2018, followed by a 2.74 point fall during December 2018, marking the worst month for loans in over seven years. He confirms Marble Point's assessment that the drawdown in loans in December was principally technical in nature, as much of the sell-off was concentrated in large, more liquid loans, with only a limited increase in the number of loans trading at deeply discounted prices (which would indicate credit risk). He notes that December 2018 was also one of the worst months on record for US equities, with the S&P 500 Index registering a total return of -9.03%, while the CSLLI and the ICE BofAML US High Yield Index (ICE BAML HYI) recorded total returns of -2.29% and -2.19%, respectively.

Commenting on the sharp decline in MPLF's NAV during November and December 2018, Shandell is keen to emphasise that this reflects Marble Point's 'mark-to-market' valuation methodology rather than any deterioration in the fundamentals of MPLF's underlying loan portfolio. He explains that the rationale for employing this valuation approach is to address the criticism that the alternative 'mark-to-model' methodology ignores market price fluctuations, as it is based on the CLO manager's internal forecast of underlying cash flows. Nonetheless, MPLF is not a forced seller of CLO equity securities when prices fall, and the key value driver for these investments remains the cash flow generation of the underlying loans held by the CLOs, rather than secondary market prices.

The manager highlights that MPLF received quarterly cash distributions totalling US$6.2m from its CLO equity holdings in January 2019, compared with US$4.2m in October 2018. While a large part of this increase comes from the first distribution by MP CLO VII following its September 2018 reset transaction, distributions by the other CLO equity positions were 9.3% higher in aggregate.

Shandell firmly believes that MPLF is well positioned to take advantage of the opportunity created by leveraged loan market volatility. He notes that, unlike many mutual funds investing in leveraged loans, Marble Point CLOs were not forced sellers during the market decline, and were able to take advantage of lower loan prices to increase levels of investment. This is demonstrated by MPLF's portfolio investments (including Marble Point CLOs) deploying over US$200m aggregate net capital during December 2018. Shandell highlights that, all else being equal, the greater investment balances resulting from loans being acquired at lower prices should lead to increased net interest income and therefore higher equity distributions from the CLOs in which MPLF is invested.

The closing of Marble Point CLO XIV on 31 December 2018 crystallised MPLF's returns on the associated LAF, in which it had invested US$28m, and the manager notes that a realised internal rate of return (IRR) of over 15% was achieved on this investment. Also during December 2018, MPLF invested US$15m of the proceeds from its US$29.5m November notes issue in a newly formed LAF, which has commenced accumulating loans to be converted into a future new CLO investment. MPLF invested a further US$4.5m into this LAF in January 2019.

Looking at the leveraged loan market at the start of 2019, the manager notes that retail net outflows moderated to US$4.7bn in January, well below the US$15bn net outflows in December 2018, but still higher than the US$2.9bn recorded in November 2018 (see Performance – page 10). Easing selling pressure, combined with opportunistic buying by many investors who believed the market was oversold, led to the leveraged loan market retracing a significant portion of its December 2018 loss, with the average par-weighted price of the CSLLI increasing by 1.72 points to 95.81 at end-January 2019, and by a further 0.42 points to 96.23 as at 19 February 2019.

Asset allocation

Investment philosophy and process: A differentiated approach

Marble Point has a conservative, differentiated approach to credit investment, with four key elements to its philosophy:

- **Margin of safety** – a safety cushion is sought to protect against possible impairment by focusing on new first lien investments with a moderate loan-to-value (LTV) ratio, as well as examining qualitative attributes.
- **Relative value** – credits possessing similar risk profiles are grouped and the loans ranked by internally assessed upside potential. Lower-ranked loans are generally candidates for sale in favour of loans with a more attractive perceived risk/return profile.
- **Active trading** – a continual focus on relative value leads to an active trading style that is integral to the pursuit of building par value and mitigating losses in the portfolio, and this also helps avoid 'stale' positions.
- **Active sourcing of investments** – Shandell and Geis have deep, longstanding relationships with major banks and dealers. With private equity firms playing increasingly significant roles in the loan allocation process, active relationships are maintained with deal sponsors to understand and communicate how Marble Point can support their needs.

Marble Point has a well-defined, disciplined and repeatable investment process, which breaks down into two main stages: loan selection and credit approval.

The loan selection process incorporates the following considerations:

- **Safety cushion** – the investment team conducts in-depth analysis of the borrower, covering a wide range of factors, to assess possible impairment risk:
  - **Fundamentals** – LTV ratios for non-distressed assets should provide a significant safety cushion, based on a detailed fundamental analysis of enterprise value, including comparison with other public and private company valuations, as well as an assessment of sensitivities to the borrower's forward projections and macroeconomic assumptions.
  - **Intangible attributes** – other factors assessed include a company's track record of repaying debt, and expected levels of free cash flow, with sought-after characteristics including low capex and working capital requirements; company or industry structural advantages; businesses with high barriers to entry or leading market share; superior returns on invested capital; and a fundamentally good reason for the business to exist.
- **Catalysts** – triggers are identified for potential change in two main areas:
  - **Credit improvement** – accelerated earnings/cash flow, asset sales, operational restructuring/cost reduction.
  - **Total return and price appreciation** – company sale (M&A), equity issuance, debt refinancing, operational/financial restructuring.
- **Relative value** – comparison is made to other names in the portfolio based on similar credit quality, not just within the same industry, but taking industry volatility into account. Comparison metrics include LTV, effective spread, yield to worst (YTW – the lowest potential IRR without the issuer defaulting), free cash flow as a proportion of debt, cash flow volatility, business momentum, and capital intensity. A new credit must compare favourably to other names in the portfolio and be accretive to returns.
- **Other considerations** – further factors assessed across two categories include:
  - **Liquidity** – size of tranche, number of dealers, quality of agent bank, market familiarity with credit, size and riskiness of underlying credit.
  - **Credit documentation** – EBITDA addbacks, limitations on debt (including incremental and other allowances), mandatory repayment terms, limitations on restricted payments.

Credits that meet the loan selection criteria are eligible to be considered for investment via the credit approval process, which comprises the following stages:

- **Idea selection** – the industry-specialist credit analysts select suitable credits for further review, based on an assessment of the following main considerations: industry; credit metrics; structure; lead agent; spread, pricing, rating and return; recovery ratio; and diversification.
- **Idea review** – the credit analysts present investment ideas for review at the investment team's morning meeting. This involves a preliminary discussion of credit positives and negatives, a preliminary relative value assessment, and review of further information required. Executable opportunities are ranked in order of priority, taking into account the timing of each opportunity.
- **Credit analysis** – the credit analyst conducts detailed research, involving a meeting with the originating bank; review of financial statements, current and historical offering documents, call replays and transcripts; conversations with agent bank professionals; and independent due diligence. The analyst develops a comprehensive, bottom-up financial model that incorporates macroeconomic and industry trends, the competitive environment and other external factors.
- **Investment team decision** – an investment memo is prepared by the credit analyst for review by the team. Further analysis is performed if requested by the CIO, head trader or another investment team member, and the memo revised as needed. The investment decision is discussed and an appropriate portfolio weighting determined.
- **Investment committee review** – only ideas supported by the investment team are submitted to Marble Point's investment committee, which comprises Marble Point CEO Tom Shandell, Marble Point Head Trader Corey Geis, Eagle Point Managing Partner Thomas Majewski and Eagle Point Principal Dan Spinner. Majority approval is required for investment recommendations to be implemented.

Following investment, there is an ongoing assessment and risk management process, with the covering analyst responsible for monitoring every position in their specialist sectors, while the team sits in an open environment, which fosters regular communication.

- **Risk management** – a proprietary portfolio monitoring report is used to evaluate credits and help make relative value decisions by comparing credit metrics and yield across portfolio holdings. The report enables the investment team to assess whether the investment thesis remains on track for each credit, and also whether portfolio yield is being optimised. Investments are designated as 'performing' or 'watch list' credits, and monitored accordingly.
- **Performing credits** – each analyst is responsible for following earnings reports and updates on relevant external factors (macro trends, cost inputs, currency, product pricing, capacity or new entrant additions, regulation). The investment team regularly discusses the relative value of performing credits.
  - **Regular meetings** – the portfolio is reviewed in regular investment meetings, with a focus on credits where there has been a change to the investment thesis. During quarterly reviews, the investment case for each credit in the portfolio is reassessed by the covering analyst and presented to the team for consideration.
- **Watch list credits** – credits that have not achieved projected financial results, par credits where the LTV has climbed meaningfully above 50%, and credits that have appreciably underperformed the portfolio average are discussed frequently within the team.
  - **Ad hoc credit updates** – analysts provide timely updates on financial results, industry developments and changes to the investment outlook via morning meetings and other real-time communications, facilitated by the open trading floor environment.

MPLF primarily obtains exposure to loans through its subsidiary MPLF Funding (which invests in loans directly), through investments in Marble Point CLO equity and debt securities, and also via Marble Point LAFs. MPLF invests in Marble Point CLOs directly and also has indirect exposure through holding minority stakes in Marble Point's CLO manager subsidiaries, which maintain risk retention interests in each CLO they manage, generally to the extent required by law or regulation.

Depending mainly on an assessment of market conditions, a Marble Point CLO manager may initiate the securitisation of a Marble Point LAF, or loans within MPLF Funding, into a Marble Point CLO; the issuance of a new Marble Point CLO; or the refinancing or reset of an existing Marble Point CLO. To the extent it has available capital, MPLF intends to obtain exposure to each new Marble Point CLO when it is issued, thereby gaining vintage period diversification across its portfolio of CLO securities, which is considered important from a risk management perspective.

MPLF may acquire Marble Point CLO securities on the secondary market, and is permitted to invest directly or indirectly in other related investments, such as CLOs or LAFs managed by third-party CLO managers; interests in other pooled investment vehicles that invest in loans or CLOs; interests in CLO collateral managers; other types of loans; and any other investment that the manager believes is consistent with MPLF's investment objective and policy.

Current portfolio positioning

Exhibit 2 shows MPLF's portfolio investments at end-January 2019. The most significant valuation changes from end-December 2018 were c 5–11% gains across MPLF's CLO equity holdings in MP CLOs III and VIII and Marble Point CLOs X and XI as these were marked up to prevailing market prices. These gains largely offset the declines reported in December 2018, confirming that no material deterioration was seen in the underlying loan portfolios of these CLOs. In December 2018, loans held by the Marble Point LAF were securitised into Marble Point CLO XIV, and capital was reallocated from MPLF Funding to a newly formed Marble Point LAF, which explains the majority of the decline in value of these investments from US$54.0m and US$27.8m at end-November 2018.

Exhibit 2: MPLF investment portfolio as at 31 January 2019

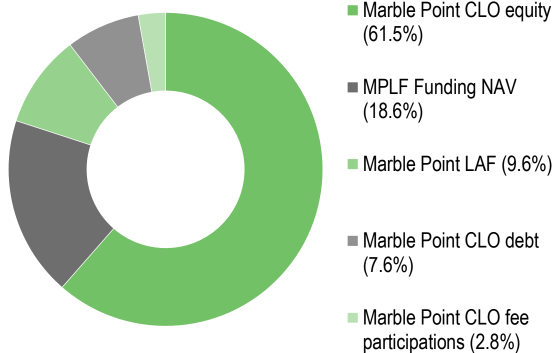
Investment	Fair value	Portfolio weight	Effective yield*	Annualised cash yield**	CLO size	Equity tranche	Marble Point ownership	Junior OC cushion***	Non-call date	Reinvestment period end
CLO equity	**US$m**	**%**	**%**	**%**	**US$m**	**US$m**	**%**	**%**		
MP CLO III	13.3	6.5	12.9	15.4	400.7	55.1	71.2	4.7	20-Oct-19	20-Oct-22
MP CLO IV	0.7	0.4	7.6	7.6	398.3	48.4	5.0	4.1	25-Jul-19	14-Jul-21
MP CLO VII	11.1	5.4	14.0	28.5	540.2	45.5	61.2	5.0	12-Sep-19	18-Oct-20
MP CLO VIII	14.1	6.8	17.9	24.3	503.4	50.0	51.7	5.2	11-Nov-18	28-Oct-19
Marble Point CLO X	23.5	11.4	8.3	19.2	502.2	50.0	86.0	5.4	15-Apr-20	17-Oct-22
Marble Point CLO XI	18.5	9.0	13.7	19.6	501.3	48.5	59.8	5.2	18-Jan-20	18-Jan-23
Marble Point CLO XII	18.9	9.2	14.6	23.6	500.5	48.7	59.5	5.1	22-May-20	16-Jul-23
Marble Point CLO XIV	26.2	12.8	12.0	N/A	400.0	38.0	86.8	5.0	31-Dec-20	20-Jan-24
Total Marble Point CLO equity	**126.3**	**61.5**	**12.7**							
CLO debt			**All-in yield**			**Debt tranche**				
MP CLO IV (Aaa)	11.0	5.4	4.0		398.3	259.0	5.0	4.1	25-Jul-19	14-Jul-21
MP CLO IV (Aa2)	1.8	0.9	4.6		398.3	42.0	5.0	4.1	25-Jul-19	14-Jul-21
MP CLO IV (A2)	0.8	0.4	5.2		398.3	19.4	5.0	4.1	25-Jul-19	14-Jul-21
MP CLO IV (Baa3)	1.0	0.5	6.4		398.3	24.6	5.0	4.1	25-Jul-19	14-Jul-21
MP CLO IV (Ba3)	1.0	0.5	9.8		398.3	24.0	5.0	4.1	25-Jul-19	14-Jul-21
Total Marble Point CLO debt	**15.6**	**7.6**	**4.7**							
Marble Point CLO fee participations	5.7	2.8	14.8							
MPLF Funding NAV	38.2	18.6	N/A							
Marble Point LAF	19.6	9.6	N/A							
Total investment portfolio	**205.3**	**100.0**								

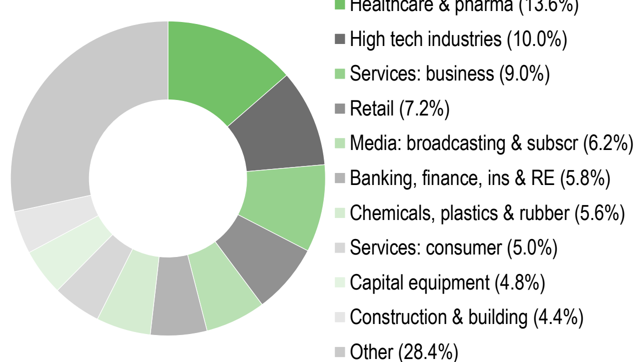
Source: Marble Point Loan Financing, Edison Investment Research. Note: *Yield to maturity based on projected cash flows. **Latest cash distribution relative to market price. ***See page 19.

Exhibit 3 shows the breakdown of MPLF's portfolio by investment category and the underlying loan exposure by industry at end-January 2019. CLO equity exposure increased from 49.9% at end-November 2018 to 61.5% at end-January 2019, reflecting the natural cycle of loan accumulation by MPLF Funding and Marble Point LAFs (which both act as CLO warehousing facilities) followed by securitisation of the loans into a new CLO issue. MPLF's CLO equity exposure was a comparable 60.9% at end-February 2018. The portfolio's underlying industry exposure is broadly spread across Moody's 35 industry groups, with the top 10 industries representing 71.9% of the portfolio at end-December 2018, compared with 70.9% at end-November 2018 and 68.5% at end-February 2018.

Exhibit 3: MPLF portfolio analysis by investment category and underlying industry exposure

Portfolio analysis by investment category at 31 January 2019	Underlying loan portfolio analysis by industry at 31 January 2019





Source: Marble Point Loan Financing, Edison Investment Research

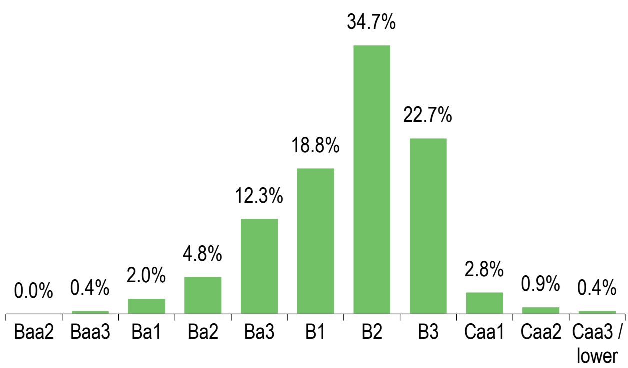
As shown in Exhibit 4, MPLF had exposure to c 300 corporate borrowers at end-January 2019, with average exposure of c 0.5%. The largest portfolio exposure to an individual borrower was 1.1% and the 10 largest exposures made up 9.7% of the portfolio (Exhibit 1), similar to end-December 2018 and end-February 2018. The average par-weighted market value of the underlying loans in the portfolio was 96.22 at end-January 2019, having recovered from 94.56 at end-December 2018, but still below the 97.11 and 99.61 average market values at end-November 2018 and end-February 2018, respectively. The underlying loan portfolio's weighted average credit rating has remained at B1/B2 since MPLF's launch, with loans concentrated in the Ba3, B1, B2 and B3 categories, although there has been a slight shift to the lower rating categories at end-January 2019 compared with end-February 2018.

Exhibit 4: MPLF's underlying loan portfolio summary and rating analysis

Summary of underlying loan portfolio characteristics

	31-Jan-19	28-Feb-18
Unique underlying borrowers	296	343
Largest individual borrower exposure	1.1%	1.2%
Average borrower exposure	0.5%	0.4%
Currency: USD exposure	100.0%	100.0%
Exposure to first lien loans	97.45%	96.10%
Exposure to defaulted borrowers	0.06%	0.1%
Average junior OC cushion	5.00%	4.71%
Average market value of collateral	96.22%	99.61
Average stated spread	3.45%	3.50%
Weighted average rating	B1/B2	B1/B2
Weighted average maturity	5.3 years	5.2 years

Moody's rating analysis of underlying loan portfolio at 31 January 2019

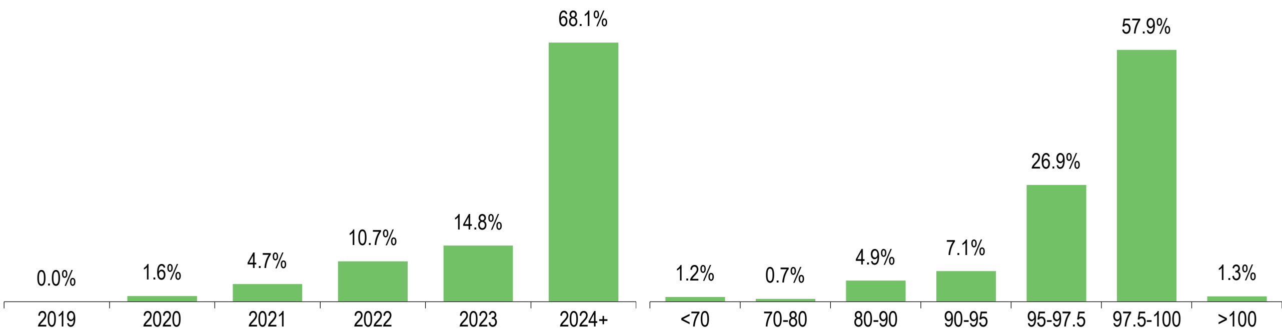


Source: Marble Point Loan Financing, Edison Investment Research

As illustrated in Exhibit 5, MPLF's underlying portfolio is skewed to longer maturities, with 68.1% exposure to loans maturing in 2024 or later as at end-January 2019, similar to the distribution at end-December 2018, but more skewed to longer maturities than at end-February 2018, when exposure to loans maturing in 2023 or later was 59.7%. The manager reports that the current portfolio's higher proportion of longer-maturity loans is consistent with the overall loan market. The price distribution of MPLF's underlying loan portfolio changed considerably during January 2019, with 59.2% trading at 97.5% of par or higher at end-January 2019 compared with 16.5% a month earlier, marking a move back towards the 77.6% and 92.9% levels recorded at end-November 2018 and end-February 2018. This shift reflects a recovery from the significant market price declines during December 2018, which resulted from an exceptionally high level of net outflows from retail loan funds, rather than any deterioration in loan fundamentals. This redemption-driven selling typically creates an attractive buying opportunity for CLOs, which have fixed-maturity financing.

Exhibit 5: Maturity and price analysis of MPLF's underlying loan portfolio

Maturity distribution of underlying loan portfolio at 31 January 2019 | **Price distribution of underlying loan portfolio at 31 January 2019**



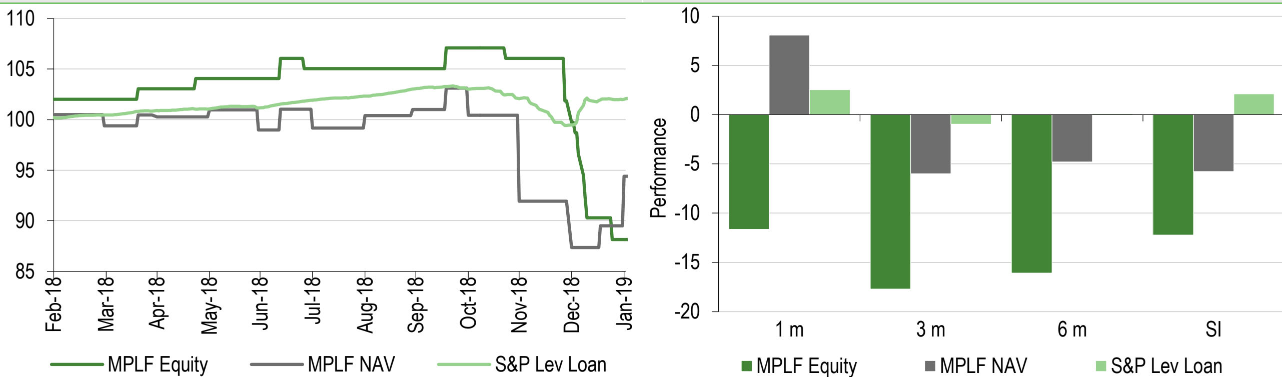
Source: Marble Point Loan Financing, Edison Investment Research

Performance: Affected by market price fluctuations

As illustrated in Exhibit 6, MPLF's NAV total return modestly lagged the S&P Leveraged Loan index from its IPO in February 2018 through to end-October 2018, but then suffered a significant setback, recording 8.5% and 5.0% declines in November and December 2018, while the S&P Leveraged Loan index saw respective declines of 0.9% and 2.5%. MPLF's weaker performance was primarily due to its conservative valuation policy, with its reported NAV reflecting a market-wide decline in CLO equity prices, while no material decline was seen in the cash generation prospects of its CLO portfolio. Marble Point's methodology contrasts with the widely used 'mark-to-model' approach, where CLO valuations are based on expected underlying cash flows and not adjusted for trading price fluctuations. While MPLF's reported NAV rebounded in January 2019, this valuation approach has made its performance appear significantly more volatile than that reported by many of its peers.

Exhibit 6: Investment company performance to 31 January 2019 in US dollar terms

Price, NAV and index total return performance, since inception rebased | **Price, NAV and index total return performance (%)**



Source: Refinitiv, Edison Investment Research. Note: Since inception (SI) date is 13 February 2018.

Loan market declines in November and December 2018 largely reflected redemption-driven selling by mutual funds invested in leveraged loans, rather than a rise in the level of defaults by corporate issuers. Net outflows from retail loan funds reportedly exceeded US$15bn in December, including US$3.5bn in the final week of the year, which represented the largest weekly outflow in the market's history. This followed US$2.9bn of net outflows in November 2018 and took total net outflows from retail loan funds to over US$20bn for the fourth quarter of 2018. Three defaults were reported in November and December 2018 among constituents of the S&P Leveraged Loan index; MPLF had exposure to only one of these – 0.07% exposure to Catalina Marketing as at end-December 2018. Only one default was reported in January 2019 and MPLF had no exposure to this issuer.

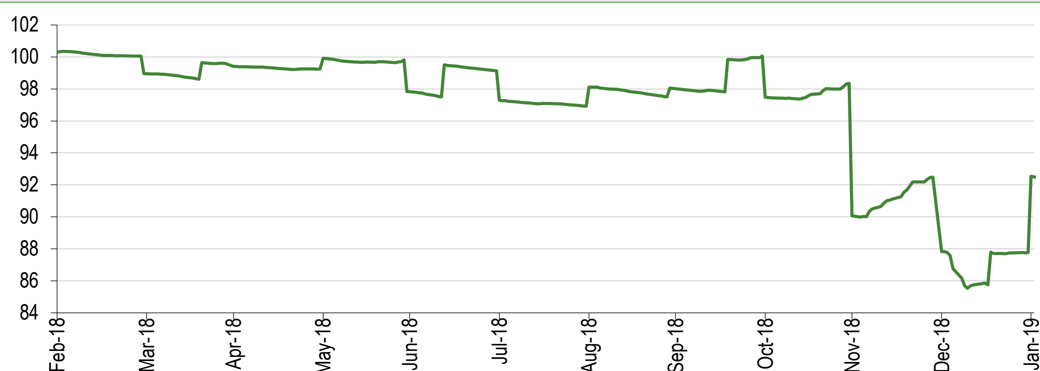
Exhibit 7: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	Since inception
Price relative to S&P Leveraged Loan Index	(13.8)	(16.9)	(16.2)	(13.6)
NAV relative to S&P Leveraged Loan Index	5.4	(5.1)	(4.9)	(7.5)
Price relative to Credit Suisse Leveraged Loan Index	(13.6)	(17.0)	(16.3)	(13.9)
NAV relative to Credit Suisse Leveraged Loan Index	5.6	(5.2)	(5.0)	(7.8)
Price relative to Credit Suisse HY Value Index	(15.4)	(18.6)	(16.6)	(14.3)
NAV relative to Credit Suisse HY Value Index	3.5	(7.1)	(5.4)	(8.2)
Price relative to S&P 500	(18.2)	(17.9)	(13.5)	(15.0)
NAV relative to S&P 500	0.1	(6.2)	(1.8)	(9.0)

Source: Refinitiv, Edison Investment Research. Note: Data to end-January 2019. Inception date is 13 February 2018. Geometric calculation.

Exhibit 7 shows MPLF's performance relative to a range of credit and equity indices over one, three and six months, and since its launch in February 2018. MPLF's share price and NAV total returns lagged the selected indices over all periods shown except for one month, when its NAV total return was in line with the S&P 500 Index and notably ahead of the leveraged loan and high-yield bond indices. MPLF's NAV performance relative to the S&P Leveraged Loan Index is shown in Exhibit 8.

Exhibit 8: NAV TR performance relative to S&P Leveraged Loan index since inception

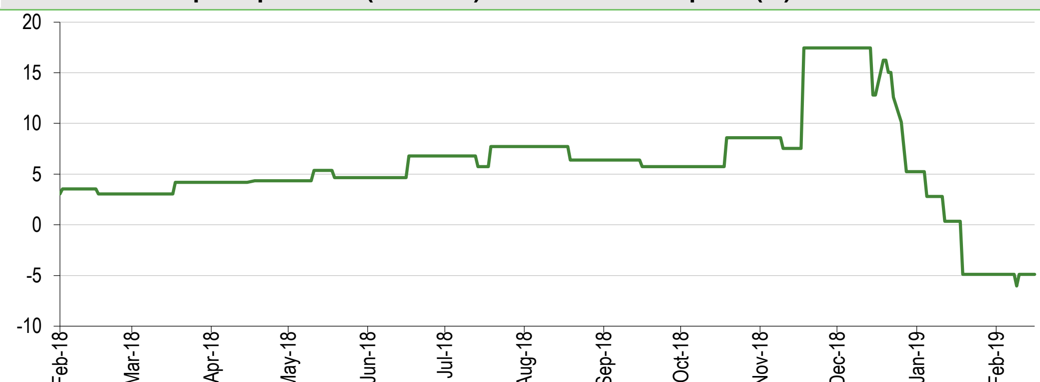


Source: Refinitiv, Edison Investment Research. Note: Inception date is 13 February 2018.

Discount: Shares now trading at a discount to NAV

As shown in Exhibit 9, MPLF's shares traded at a premium to NAV from its IPO up to end-January 2019, when its share price had not reacted to the recent rebound in its NAV. At 28 February 2019, the share price stood at a 4.9% discount to the latest reported (end-January 2019) NAV per share, which compares with the average 5.7% premium since MPLF's launch. MPLF has no strict discount control policy, but shares may be repurchased if they trade at a three-month average discount wider than 5%, measured at each month end. Repurchases will only be made at prices below the prevailing NAV per share, when the directors believe such purchases will be value accretive.

Exhibit 9: Share price premium/(discount) to NAV since inception (%)



Source: Refinitiv, Edison Investment Research

Capital structure and fees

MPLF currently has a single share class, with 205.7m ordinary shares in issue. The directors have annually renewable authority to make market purchases up to 14.99% of MPLF's outstanding ordinary shares. There are no rules restricting the ability of the directors to issue additional shares on a non-pre-emptive basis at any time. The directors may issue additional shares, pursuant to a placing programme or otherwise, if they determine this to be in the best interests of shareholders and MPLF as a whole. No shares have been allotted or repurchased since MPLF's IPO in February 2018, when it raised c US$40.5m in net proceeds through issuing 42.5m ordinary shares at US$1.00 per share, and all of its 205.7m ordinary shares were admitted to trading on the Specialist Fund Segment (SFS) of the London Stock Exchange.

Prior to its IPO, MPLF had two classes of share: ordinary redeemable participating management shares (founder shares), and non-voting, ordinary redeemable participating shares (co-investor shares), which had been issued over time since MPLF's incorporation, in connection with previous capital raises. All founder and co-investor shares in issue were converted into ordinary shares at a ratio of c 1:1.23 immediately prior to admission to trading on the SFS, so that there were 163.2m ordinary shares in issue and the founder shares and co-investor shares ceased to exist. The holders of these 163.2m shares were subject to a lock-up agreement for 12 months following initial admission, which restricted them from selling, transferring or otherwise disposing of the shares. The end of this lock-up (which covers 79% of the outstanding shares) in February 2019 could lead to an increase in share liquidity, which has been relatively low since MPLF's IPO.

Sumitomo Mitsui Trust Bank (which provides a non-recourse US$200m revolving credit facility to MPLF Funding) has an option to acquire up to US$1.0m in MPLF ordinary shares, at the US$1.00 issue price if the option is exercised within 12 months of initial admission, or at the most recently determined or estimated NAV per share if the option is exercised at a later date.

A continuation vote will be proposed at MPLF's first AGM following the fourth anniversary of its IPO unless, prior to this anniversary, MPLF has raised US$400m or more in capital – calculated as MPLF's NAV at initial admission plus gross proceeds of further capital raises, less gross amounts paid to shareholders through share buybacks, repurchases or redemptions. If the continuation resolution is not passed, the directors are required to put forward proposals for reconstruction or reorganisation of the company for shareholder approval within six months of the vote.

Borrowings

As set out in its memorandum of association, MPLF is permitted to borrow up to 20% of its gross assets, at the time of borrowing. This limit excludes non-recourse financing obtained by MPLF Funding or any other entity in which MPLF is invested. MPLF previously held a one-year US$10m revolving credit facility with China Merchants Bank, which expired in October 2018. In November 2018, MPLF issued US$29.5m aggregate principal of 7.50% senior unsecured notes due in 2025, providing US$28.4m in net proceeds, of which it invested US$15m in December in a newly formed LAF. The US$29.5m borrowings equated to 16.6% of net assets at end-January 2019, while net gearing was 15.7% at this date.

In September 2016, MPLF Funding entered into a US$200m revolving credit facility (which is non-recourse to MPLF) with Sumitomo Mitsui Trust Bank. MPLF Funding utilises the facility to acquire loans directly – these loans should generate net interest income while being accumulated in advance of future Marble Point CLO issuances. Advances under this facility accrue interest at an annual rate of Libor+1.25% plus a 0.10% administrative fee, and there is no undrawn cost. The facility's earliest maturity date is 16 April 2021, and this automatically extends to 16 September 2021 under certain circumstances. MPLF Funding may draw on the facility up to an 80% loan-to-value ratio, and at end-September 2018, US$95.6m was drawn (78% LTV ratio).

Management and incentive fees

MPLF’s investments are only subject to one layer of management fees, and the manager sees MPLF’s overall fee structure as one of the most investor friendly among its peers. Marble Point LAFs do not pay any management fees to Marble Point, and no fees are borne by MPLF’s CLO debt investments or fee participation interests. As a result, 20% of MPLF’s portfolio investments at end-January 2019 (see Exhibit 2) were not subject to any fees.

As MPLF’s investment manager, Marble Point is entitled to a management fee equal to 0.40% per annum of MPLF’s consolidated total assets, excluding assets managed by Marble Point. To date, all MPLF’s investments have been in Marble Point-managed assets and it is expected that they will continue to comprise the majority of MPLF’s investments in future. Marble Point is also entitled to be reimbursed for reasonable costs and expenses. CLOs in which MPLF is invested generally each pay management and incentive fees, which in certain cases are greater than 0.40%. MPLF indirectly bears these fees as they are deducted from the net returns of the CLOs. MPLF Funding pays Marble Point a management fee equal to 0.40% per annum of its average gross assets.

Marble Point is usually entitled to receive CLO management and incentive fees at levels agreed at the time of issuance, in accordance with prevailing market conditions. As a direct or indirect investor in the equity tranche of Marble Point CLOs, MPLF bears its pro rata portion of such fees. However, MPLF does not bear CLO management fees in excess of 0.40% per annum or CLO incentive fees in excess of 20% over a 12% hurdle. Where fees are higher, MPLF receives a fee participation interest or rebate, except where the CLO interest has been acquired in the secondary market.

Based on assumed gross issue proceeds of US$100m, MPLF’s total annual operating expenses were forecast to be c 0.82% of its estimated unaudited net asset value on initial admission. These expenses primarily comprise directors’ fees, administration and audit fees, and do not include fees payable on underlying investments, where MPLF receives returns net of fees. Adjusting for the actual gross IPO issue proceeds of US$42.5m, we estimate MPLF’s ongoing charges at 1.05%.

Dividend policy and record

MPLF pays dividends quarterly in April, July, October and January. It has an 8.0% target annualised yield based on its US$1.00 per share IPO price, with the intention to raise the target yield to 10.0% one year after its listing in February 2018. Based on its US$0.82 share price at 28 February 2019, MPLF’s current annualised dividend yield is 9.8%. If the quarterly dividend is lifted as intended from April 2019, the prospective annualised yield would rise to 12.2%, based on the same share price.

MPLF’s original dividend policy was to commence distributions following the first anniversary of its initial closing date (2 August 2016), with the intention to pay an initial dividend of 2.0% of net asset value each quarter (equating to an 8.0% annualised return), with the target dividend subsequently increasing to 2.5% a quarter. MPLF paid an inaugural dividend of US$0.0238 per share (US$0.0194 per ordinary share – adjusting for IPO share conversion ratio) in December 2017, representing 2.0% of its net asset value as at end-September 2017. In January 2018, MPLF paid a dividend of US$0.0142 per share (US$0.0116 per ordinary share – adjusting for IPO share conversion ratio) in respect of the portion of the first quarter of 2018 prior to its IPO.

In April 2018, MPLF paid a US$0.0104 per share dividend in respect of the portion of the first quarter of 2018 following its IPO, equating to an annualised distribution in line with the targeted 8.0% dividend yield. In July and October 2018 and January 2019, MPLF paid US$0.02 per share dividends in respect of the second, third and fourth quarters of 2018. This took total post-IPO dividends for 2018 to US$0.0704 per share, which represents an 8.0% annualised yield based on the IPO price of US$1.00 per ordinary share, pro-rated for the period from MPLF's IPO and admission to trading on 13 February 2018.

Peer group comparison

Exhibit 10 shows a comparison of MPLF with a selected peer group of funds from the AIC Sector Specialist: Debt and AIC Sector Specialist: Financials sectors that have significant holdings in CLO securities or similar investments. Carador Income Fund has been excluded as it has commenced a managed wind-down. As less than one year's data is available for MPLF, we show performance over six months and since MPLF's inception to allow comparison to be made, while also showing longer time periods for the peers, to give greater context to the short-term performance data.

MPLF's NAV total return is the lowest in the peer group over six months and over the c 11.5 months since its inception. This is primarily due to the sharp mark down in MPLF's NAV in November and December 2018, which is due to MPLF's conservative policy to reflect market pricing in its reported NAV. This contrasts with the more widely used 'mark-to-model' valuations, which are based on expected underlying cash flows and not adjusted for trading price fluctuations. Market declines in these two months reflected redemption-driven selling by mutual funds invested in leveraged loans, rather than a high level of defaults – three defaults were reported among constituents of the S&P Leveraged Loan index, and MPLF had only 0.07% exposure to one of these issuers.

Exhibit 10: Selected CLO investment peer group as at 28 February 2019* in sterling terms

% unless stated	Market cap £m	NAV TR 6 mth	NAV TR SI**	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Premium/ (discount)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Marble Point Loan Financing	126.8	(5.1)	0.1				(4.9)	1.05***	No	116	9.8
Blackstone/GSO Loan Financing	288.4	2.5	5.2	6.9	40.4		(5.7)	0.47	No	100	12.0
Chenavari Toro Income Fund	216.5	2.5	4.3	8.2	43.4		(19.2)	1.39	Yes	100	10.1
EJF Investments	118.1	2.2	9.7	10.7			2.9	2.40	Yes	100	5.8
Fair Oaks Income 2017	288.0	2.9	10.0	12.7	73.0		(4.8)	0.66	Yes	100	13.2
TwentyFour Income	477.5	2.3	3.1	3.2	28.5	35.5	(0.2)	0.92	No	100	6.3
Volta Finance	216.1	(1.5)	1.6	3.3	56.5	59.6	(10.7)	1.88	Yes	117	9.0
Average	**247.3**	**0.8**	**4.9**	**7.5**	**48.4**	**47.5**	**(6.1)**	**1.25**		**105**	**9.5**
Rank in peer group	**6**	**7**	**7**	**N/A**	**N/A**	**N/A**	**4**	**4**		**2**	**4**

Source: Morningstar, Edison Investment Research. Note: *Performance to end-January 2019. **Since MPLF's inception (SI) date is 13 February 2018. ***Edison estimate. TR = total return in sterling terms. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

With its share price having moved to a discount to NAV at end-January 2019, MPLF's current 4.9% discount is at the median within the peer group, with only one of the peers trading at a premium. Our estimate of MPLF's ongoing charge is below the peer group average. MPLF's dividend yield is slightly ahead of the peer group average, and it has a target to increase its payout from 8% to 10% of the US$1.00 per share IPO price one year after its February 2018 listing, which would lift its yield to c 12% based on the current US$0.82 share price.

The board

MPLF's board comprises five non-executive directors, four of whom are independent of the investment manager. The current independent directors were all appointed in December 2017, when former directors Dan Spinner and Chris Le Page retired from the board. Chairman Robert Brown is a financial services professional with over 20 years' experience in the UK, Europe and the US, encompassing asset management, private banking and investment banking. John Falla is a chartered accountant and investment professional with over 30 years' experience in the UK and Channel Islands. Sandra Platts worked at Kleinwort Benson from 1986 to 2010, serving as chief operating officer for the Channel Islands business from 1992. She is a director of NB Global Floating Rate Income Fund, UK Commercial Property REIT and Sequoia Economic Infrastructure Fund. Paul Greenberg has been a fund manager focused on equity and debt investments in special situation, distressed and bankrupt corporations for the past 17 years. He is currently managing partner of Clermont Capital, a family office with a focus on private equity and fixed income markets.

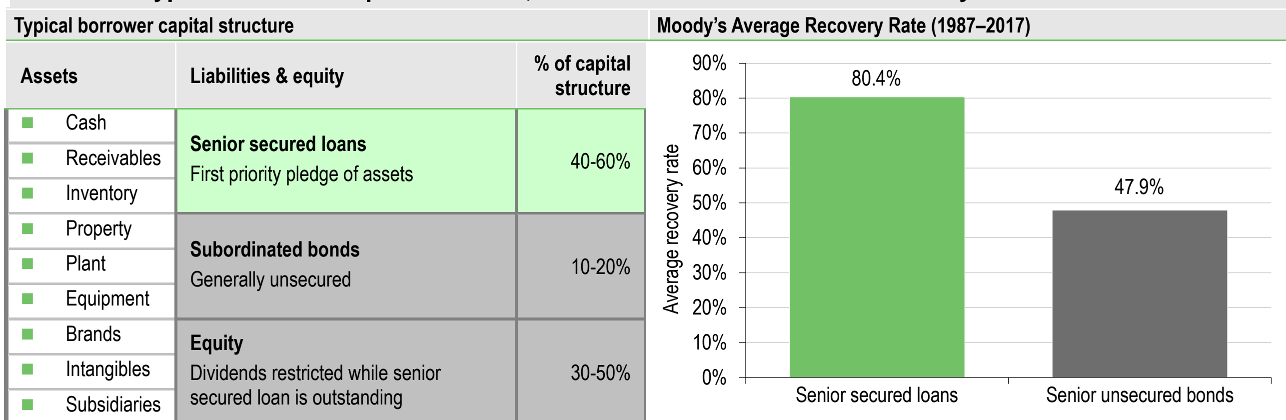
Non-independent Director Thomas Majewski was appointed to MPLF's board in 2016 as a nominee of its investment manager Marble Point. He has spent his entire career in structured finance and credit markets, and his experience in the CLO market dates back to the 1990s. Majewski serves on the board of Marble Point and holds an indirect minority interest. He is also managing partner and a board member of Eagle Point, holding a minority interest. Eagle Point is the sole member of EPCM Holdings, a shareholder of MPLF and the holder of a majority interest in Marble Point.

Appendix: Introduction to leveraged loans and CLOs

Leveraged loans are loans issued by companies that have relatively high levels of debt, which consequently have lower credit ratings (generally Ba1/BB or lower) and offer higher yields than loans issued by investment-grade companies that present lower credit risks due to their lower levels of gearing. Many companies issue leveraged loans as part of a leveraged or management buyout (LBO or MBO) transaction when they are acquired by a private equity investor.

Companies that issue leveraged loans often also borrow through issuing high-yield bonds, with bonds usually paying interest at a fixed rate, while loans generally pay interest at a floating rate, typically measured as a margin or spread over a benchmark rate such as Libor. Loans are typically secured on the assets of the company, while bonds are usually unsecured. This means that loans are repaid in priority to bonds in the event of a default, and consequently average recovery rates historically have been much higher for loans than bonds (Exhibit 11). Loan agreements also usually contain covenants that give lenders more control over the borrower's actions. While less restrictive 'covenant-lite' loans now account for c 75% of the US leveraged loan market, Standard & Poor's reports similar historical default rates for these loans relative to fully covenanted loans. However, a rise in the prevalence of loan-only capital structures has led Moody's to project a decline in first-lien loan recoveries to 61%, with second-lien debt recoveries projected to fall to c 14%.

Exhibit 11: Typical borrower capital structure, and historical loan and bond recovery rates



Typical borrower capital structure

Assets	Liabilities & equity	% of capital structure
Cash Receivables Inventory	**Senior secured loans** First priority pledge of assets	40-60%
Property Plant Equipment	**Subordinated bonds** Generally unsecured	10-20%
Brands Intangibles Subsidiaries	**Equity** Dividends restricted while senior secured loan is outstanding	30-50%

Source: Marble Point Loan Financing, Moody's Investor Service

Statistically, companies with higher leverage and lower credit ratings are more likely to default on debt repayments than investment-grade companies. The higher the perceived risk of default, the greater the yield demanded by investors to hold the debt. The primary attraction of leveraged loans is the high yield that they offer to investors, who can seek to mitigate the risk of default in a number of ways, such as by holding a diversified portfolio of loans, conducting their own detailed credit analysis prior to investing, and carefully monitoring the loan investments they hold.

Collateralised loan obligations or CLOs are closed-ended investment vehicles that have been structured specifically to invest in leveraged loans, aiming to maximise investment returns while minimising the risks inherent in its leveraged structure. A CLO is financed by a series of interest-paying debt tranches (CLO debt) and a smaller equity investment class (CLO equity). CLOs typically hold a portfolio of 80 to 350 leveraged loans, highly diversified across industry sectors,

covering a range of non-investment-grade credit ratings, with low concentration of exposure to individual borrowers. CLO portfolios are actively managed by a collateral manager, who can buy and sell holdings to improve the potential returns from the portfolio as market conditions change, as well as being able to refinance the CLO's debt when more favourable rates can be secured.

CLO equity returns are driven by the arbitrage between the cost of the CLO debt tranches and the interest income generated by the loan portfolio. In Exhibit 12, the weighted average cost of the debt tranches is Libor+190bp. If the loan portfolio generates an average coupon of Libor+375bp, the arbitrage opportunity available for CLO equity investors is about 185bp, before deducting fees and expenses. This arbitrage is magnified by the c 9:1 embedded leverage in the CLO for the equity tranche. CLO managers' fees typically comprise a senior management fee of c 15bp, which is paid prior to servicing the CLO debt, and a subordinated management fee of c 35bp, which is paid after servicing the CLO debt before excess interest is distributed to CLO equity holders. The CLO manager is also usually entitled to receive an incentive fee, typically 10–20% of returns above a CLO equity IRR hurdle of 8–12%. Net of fees, a CLO equity would generally be expected to achieve an annualised return of 10–15%.

Exhibit 12: Illustrative CLO capital structure

Assets	S&P rating	Moody's rating	Coupon (Libor+)		Liabilities	S&P rating	Moody's rating	% of total	Coupon (Libor+)
Portfolio of leveraged loans	BBB	Baa2			Senior tranche	AAA	Aaa	63	1.30%
	BB	Ba2	2.75%-5.00%			AA	Aa2	10	2.00%
	B	B2	Wavg 3.75%			A	A2	7	3.00%
	CCC	Caa2			Mezzanine tranche	BBB	Baa2	6	4.00%
Cash for reinvestment or repayment						BB	Ba2	4	6.00%
					Equity tranche	N/A	N/A	10	

Source: Edison Investment Research

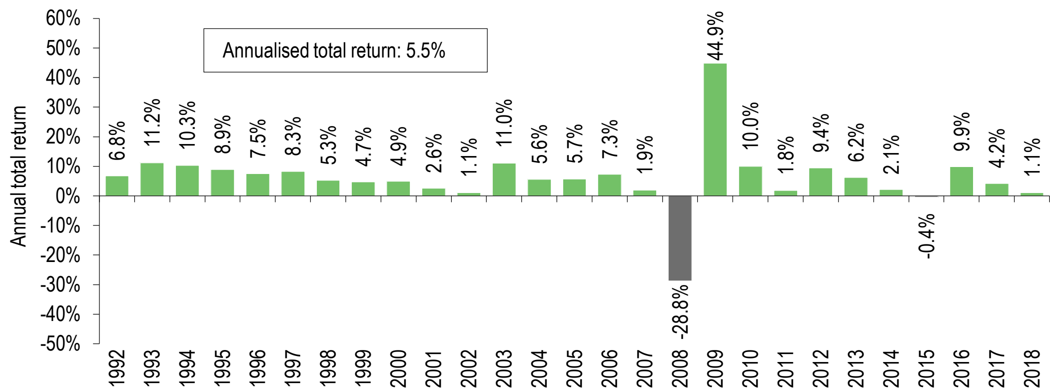
While leveraged loans are rated below investment grade, most CLO debt tranches are rated investment grade as they benefit from diversification, credit enhancements, and subordination of cash flows. CLO debt securities are floating rate investments that generally offer a higher yield relative to other equivalently rated debt securities. CLO equities are higher-risk investments that are entitled to the excess cash flows from the loan portfolio after interest and principal payments to the CLO debt tranches, management fees and other costs. Although CLO equities bear the first risk of default in the loan portfolio, they offer investors higher returns than CLO debt, and also potential upside from periods of loan price volatility, when CLO managers can often take advantage of a CLO's fixed-term financing to purchase loans at a significant discount to their par value.

The main perceived risk of CLOs is that they are highly geared and therefore vulnerable to incurring considerable losses in a market downturn or in the event of defaults occurring in the portfolio. However, while CLOs have a substantial level of debt funding relative to the equity component (typically c 9:1 debt to equity), CLO debt securities are issued with maturities that are longer than the typical five-year maturity of loans held in the portfolio, and cannot be redeemed early by the holder. Additionally, CLOs are closed-ended, with a fixed life, and do not have to manage inflows and outflows from investors, unlike mutual funds that invest in leveraged loans.

Leveraged loan and CLO performance track record

Historically, leveraged loans and CLO returns have been more consistently positive than might be expected given the generally perceived risks over their highly geared nature. Looking at calendar year returns, the CSLLI (which tracks the investable universe of US dollar denominated leveraged loans) recorded a 5.5% annualised return from 1992 to 2018 (Exhibit 13). During this 27-year period, only 2008 and 2015 saw negative returns (-28.8% and -0.4%, respectively), and both were followed by a year with a more than offsetting positive return (+44.9% in 2009 and +9.9% in 2016).

Exhibit 13: Credit Suisse Leveraged Loan Index historical annual total returns

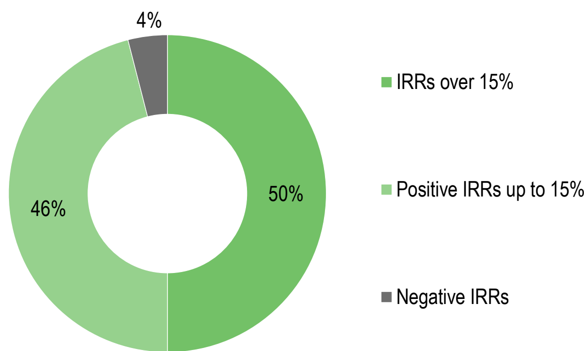


Source: Bloomberg, Edison Investment Research

Marble Point's analysis of US CLO equities issued between 2002 and 2011 shows that 50% generated internal rates of return (IRRs) of more than 15%, while 46% generated IRRs of up to 15%, and only 4% generated negative returns (Exhibit 14 left-hand chart).

Exhibit 14: Historical CLO equity returns and default rates

Distribution of US CLO equity IRRs for 2002–11 vintages



S&P CLO tranche defaults vs. corporate bond default history (cumulative)

S&P credit rating	US CLO default rate	US corporate default rate		
	1996-Q218	5 year	10 year	15 year
AAA	0.0%	0.4%	0.8%	1.2%
AA	0.1%	0.4%	1.0%	1.5%
A	0.3%	0.7%	1.8%	2.8%
BBB	0.5%	2.0%	4.4%	6.1%
BB	1.5%	8.2%	14.8%	18.5%
B	1.1%	19.2%	27.0%	30.8%

Source: Marble Point Loan Financing, Standard & Poor's Rating Services, Edison Investment Research

Standard & Poor's data shows that historically CLOs have experienced significantly lower default rates than corporate bonds (Exhibit 14, right-hand table), with AAA-rated CLO tranches never experiencing a default or loss of principal, even during the global financial crisis.

CLO operation

Managed CLOs have a dynamic asset pool, with loans actively bought and sold by the manager to improve returns and reduce the risk of exposure to a default. Interest and principal cash flows generated by the loan portfolio are treated separately and distributed to CLO debt and equity holders in a predefined sequence, known as the payment waterfall, with the most senior tranches receiving payments first. Under normal circumstances, interest received on the loans is used to pay CLO debt interest and fees, while loan repayments are reinvested in loans or used to redeem CLO debt, depending on the period of the CLO's lifecycle.

Senior secured loans are usually prepayable at par, with borrowers repaying part or all of a loan ahead of its maturity to reduce interest costs, and such loan prepayments are reinvested or used to redeem debt alongside scheduled loan principal repayments. While leveraged loans typically have a term of five to seven years, S&P Leveraged Loan index data shows a c 35% average annual rate of leveraged loan principal repayment (from prepayments and mandatory amortisations) from 2002 to 2017, while the lowest annualised rate over a two-year period (2008–09) was c 12%.

Due to the dynamic nature of the loan portfolio, the CLO manager has a significant degree of influence over the returns generated by a CLO's assets, and consequently the level of excess returns distributed to CLO equity holders. Alignment of interest between CLO managers and CLO debt and equity holders is achieved through the payment of performance-linked incentive fees, as well as part of the management fee being subordinated to debt interest payments.

CLO lifecycle

Each CLO has a defined lifecycle during which loans are purchased, managed and redeemed, and cash is returned to debt and equity investors. The lifecycle can be divided into five periods:

- **Warehousing (three to six months)**: the CLO manager acquires loans on behalf of the CLO prior to the CLO closing date.
- **Ramp-up (one to two months)**: following the closing date, the CLO manager purchases additional loans to complete the initial portfolio, using the issuance proceeds.
- **Reinvestment (four to five years)**: manager can trade the loans in the CLO portfolio and reinvest all loan repayment proceeds.
- **Non-call (first two years of reinvestment)**: CLO debt holders earn a yield spread specified at closing, after which the majority equity tranche holder can call or refinance debt tranches.
- **Amortisation (one to four years)**: after the reinvestment period ends, the manager pays down CLO debt tranches in order of seniority as the underlying portfolio loans are repaid, then distributes excess proceeds to CLO equity holders.

The periods within the CLO lifecycle are defined by key dates:

- **Pricing date** – often three to four weeks before the closing date, when the arranger prices the CLO debt tranches by calculating issuance spreads and prices.
- **Closing date** – when the CLO comes into legal existence, the tranches are issued and their interests start to accrue, and the loan assets are transferred from the warehouse to the CLO.
- **Effective date** – when the CLO's portfolio of loan assets is 100% invested.
- **Legal maturity date** – the contractual maturity date of the CLO debt tranches.
- **Call date** – when the CLO is called prior to its legal maturity date at the option of the CLO equity investors by majority vote.

Refinancing, reset, call, and 'call and roll' transactions

After the non-call period has ended, CLO equity holders can elect to reset the CLO structure, refinance selected CLO debt tranches, or call the CLO and redeem all CLO debt. Resets and refinancings involve one or more CLO debt tranches being repriced when loan spreads narrow significantly, which has the effect of reducing interest payments to CLO debt holders, and therefore a refinancing can serve to increase the excess cash flows that are payable to CLO equity holders. Reset and refinancing transactions involve the CLO issuer calling the original CLO debt tranches and issuing new CLO debt tranches with lower spreads, and the proceeds of the new debt issued are used to redeem the existing debt. In a reset transaction, the CLO debt is issued with a later maturity and the reinvestment period extended accordingly, while in a refinancing transaction the reinvestment period and CLO debt maturity are unchanged.

CLO equity investors can also call the CLO by electing for the CLO manager to liquidate all the loan assets in the portfolio, redeem all the CLO debt tranches, and return excess proceeds to the CLO equity holders. This generally occurs during a CLO's amortisation period, when the projected rate of return on the CLO equity becomes less attractive than the prospective return on alternative investments. As the most senior, and lowest cost, CLO debt tranches are repaid first during the amortisation period, the CLO's weighted average cost of debt increases over time, resulting in a decline in the return to CLO equity holders.

'Call and roll' transactions effectively make use of a significant portion of an existing CLO's loan assets to recast and renew the CLO's liabilities into a new CLO with updated (often lower) pricing and a new extended maturity. During 2017, there were seven refinancing, reset and 'call and roll' transactions involving the Marble Point CLOs held directly or indirectly in MPLF's investment portfolio, representing the issuance of approximately US$3.1bn of CLO debt and equity. Each of these transactions resulted in a reduction of the CLO's weighted average cost of debt or an extension of the CLO's reinvestment period, which allowed the managers of the Marble Point CLOs to continue actively managing the loan portfolio underlying each of these CLOs.

CLO structural protections

CLO managers are required to ensure that each CLO operates within a defined framework, and a number of monitoring tests are regularly performed to ensure adherence to various performance metrics. Tests are carried out at each payment date throughout the life of the CLO, starting at the effective date, and the metrics most commonly tested are as follows:

- **Overcollateralisation (OC)** – this test compares the value of outstanding CLO debt with the loan portfolio value, to ensure sufficient assets are held to repay the debt.
- **Interest coverage (IC)** – this test compares the income being generated by the loan portfolio with the CLO debt interest payments, to ensure a low risk of default.
- **Weighted average life (WAL)** – the weighted average life of all loans in the portfolio must be held below a defined maximum level, linked to the final contractual maturity of the CLO.
- **Weighted average spread (WAS)** – the average effective interest rate spread over Libor for the loan portfolio indicates whether income should be sufficient to cover interest on liabilities.
- **Weighted average rating factor (WARF)** – a measure of the average credit rating of the portfolio, which is an indicator of the portfolio's average credit risk.

The OC tests are the most onerous tests applied to the CLO and therefore receive the greatest attention. An OC test compares the par value of the loans in a CLO's investment portfolio (adjusted for defaults and imminent defaults, where applicable) to the par value of the CLO debt securities it has issued. The consequence of an OC test failing to meet its threshold is that distributions to CLO equity holders are withheld and used to repay the most senior AAA-rated CLO debt down to a level where the OC test is back in compliance. There is no forced sale of loans or any mandatory injection of equity capital. The CLO manager can lower the risk of the OC test failing to meet its threshold during the reinvestment period by using loan redemption proceeds to purchase loans at below par value, known as par building.

The most junior OC test is the test that relates to the lowest-rated CLO debt tranche (generally BB or B rated), which ranks directly above the CLO equity in the CLO capital structure. This test therefore defines the level at which the CLO manager must maintain the total par value of the loan portfolio above the total par value of the CLO debt tranches, and this indicates the minimum level of assets that are attributable to the CLO equity. This test threshold is typically around 105%, which indicates that a minimum c 5% of the loan portfolio is attributable to the CLO equity holders, compared with its typical c 10% share of the CLO liabilities. Where a **junior OC cushion** is quoted for a particular CLO, this indicates the level of loan assets at par value in excess of the junior OC threshold, so a 5% cushion indicates that c 10% of the loan portfolio is attributable to the CLO equity holders, where the threshold is 105%.

Many CLOs also have an interest diversion test (IDT), which applies only to the most junior debt tranche and has a slightly more conservative threshold than the OC test, so is triggered earlier. When the IDT threshold is breached, up to half of the excess interest payments that would accrue to the CLO equity are diverted to reinvest in loans or repay the most senior CLO debt tranches.

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