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Having been pronounced dead by many in 2008, collateralized loan obligations (CLOs) have arisen like a phoenix in the aftermath of the global credit crisis. Unlike their acronymic relatives (including CDOs, SIVs, RMBS, and others), under extreme economic duress, CLO performance exceeded the wildest expectations of investors. Consequently, the last two years have seen a remarkable resurgence in the U.S. CLO market and the rebirth in 2013 of the European CLO market. At the writing of this article, U.S. CLO volume during 2013 has already exceeded the $54 billion in US CLOs that closed in 2012.[1] The European CLO market, which was dormant in 2012, witnessed €2.4 billion of issuance in the first half of 2013, and some have forecasted €10 billion of issuance by year-end. Record issuance has created a surge in demand for CLO-eligible loans that must be satisfied if this upward trend is to continue. However, the choppiness of the U.S. and global mergers and acquisitions (M&A) markets (and consequently, the leveraged loan market) has limited the supply of loans in which CLO managers may invest.

Meanwhile, there is a serious call for project finance loans to fund exponential growth in infrastructure development needs. The Organization for Economic Cooperation and Development (OECD) has estimated that $50 trillion of capital is needed to satisfy global infrastructure requirements through 2030 (OECD [2013]). Yet, these infrastructure needs are multiplying at a time when traditional project bank lenders are looking for balance sheet relief in the wake of Basel III and many (particularly in Europe) have been disposing of their project loan assets. Standard & Poor's "expects banks to diminish lending in coming years, leaving capital markets with a bigger financing role for many massive infrastructure undertakings" and expects capital market funding for projects to double in the short term and this "could accelerate with successful securitization" (Buswick [2012]).

Project loans are perhaps the largest class of commercial loans that have not taken an active role in the CLO market, and the CLO provides a mechanism for monetizing this relatively illiquid class of loans. Recent private placements and 144A offerings of project debt in the institutional markets show the appetite that non-traditional lenders have for project loans, as does the growth of private infrastructure funds that are raising billions of dollars to invest in infrastructure-related assets in both developed and developing countries.

These three phenomena suggest that the stars may be in alignment for a comeback of the project finance (PF) CLO. PF CLOs are back in the news again.[2] This article will discuss the numerous attributes of project finance loans that make them a particularly

attractive asset class for CLOs and also those that pose challenges to their securitization.

HISTORY OF PF CLOs

Despite the depth of the pre-credit-crisis CLO market, from 1998 through 2008, only a dozen or so project finance loan securitizations were launched, most of them being cash-flow CLOs and synthetic CLOs (i.e., with the CLO issuer selling credit protection against the project loan portfolio) and the remainder being project finance collateralized bond obligations (CBOs).[3] As a general matter, the PF CLOs 1) had portfolios that were largely static with the portfolio in place at closing, 2) involved little or no completion risk on the projects involved, and 3) contained relatively little disclosure about the specific projects involved. Some were focused on specific regions and industries.

MOTIVATIONS OF THE PF CLO SPONSOR

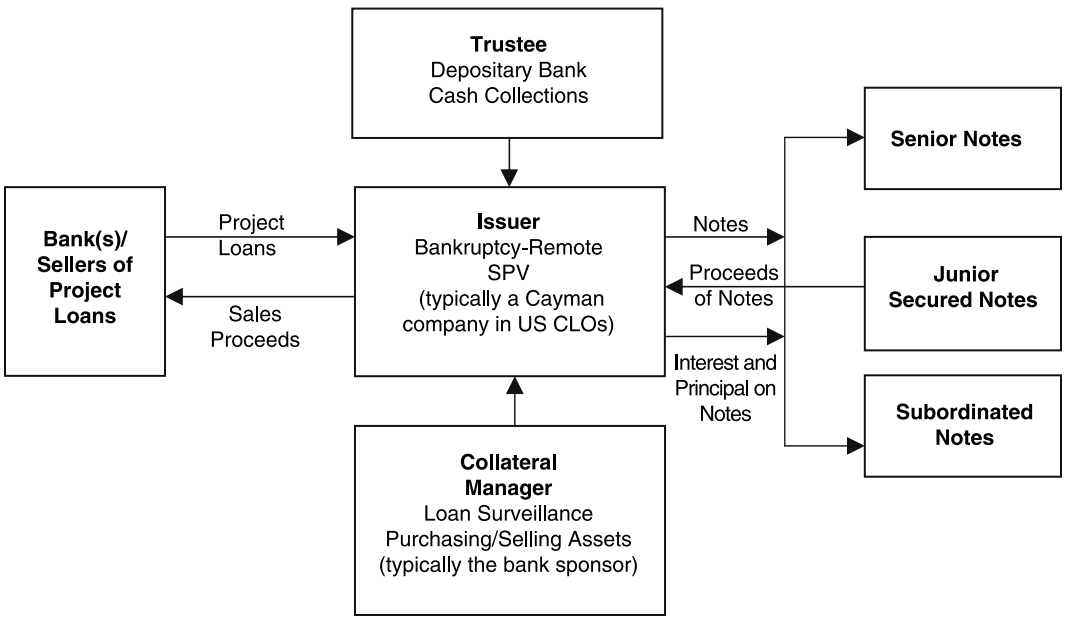
Traditional CLOs have, for the most part, been sponsored by investment advisors looking to play the arbitrage between the yield on commercial loans and the interest rates of the various tranches of debt issued by the CLO. As a general matter, the portfolios are subject to broad reinvestment rights and the portfolio manager receives a senior management fee, a subordinated management fee, and sometimes an incentive management fee equal to a portion of the return on the equity tranche of the CLO (often issued in the form of subordinated notes) after a specified internal rate of return (IRR) hurdle. The portfolio manager seeks capital appreciation of assets through sales and reinvestment at par and below.

In contrast, the sponsors of PF CLOs historically have been the banks that originated the project loan portfolios. In setting up a so-called "balance sheet" CLO, the sponsoring bank uses the CLO as a tool for capital management and the funding and management of lending limits. Acting as the portfolio manager for the CLO, the sponsoring bank can free itself from increasing capital requirements that would result from continuing to hold those loans while at the same time retaining management control (and generating fee income) over the assets in a way that need not strike any fear in its borrowers (or the PF market generally) that their relationship bankers have offloaded their deals or exited the market.

STRUCTURE

The structure of a PF CLO is generally the same as a CLO involving leveraged loans, as shown in the Exhibit.

EXHIBIT
PF CLO Structure



Just as in the case of a leveraged loan CLO, the economics of the PF CLO are derived from diversification (by obligor, industry, and geography), probabilities of default, expected recoveries following default, and credit enhancements—for example, tranching the CLO securities, excess spread (the excess of interest income over interest expense), and occasionally, cash reserves. The other necessary parties to a PF CLO will be the rating agencies, hedge providers, and key counterparties to the underlying projects.

DIFFERENCES BETWEEN PROJECT LOANS AND COMMERCIAL LOANS

Although the structural elements of a PF CLO are no different than those of an ordinary CLO, project loans are a unique breed and differ in material ways from the leveraged loans that typically compose a CLO loan portfolio. Corporate loans are full recourse to the borrower and generally secured (on a senior secured basis) by all of the borrower's assets, although an ordinary CLO portfolio may include a limited number of second lien loans, holdco loans (i.e., secured only by equity of the obligor), bonds, and unsecured loans. Corporate loan proceeds are for general working capital purposes. They often have back-ended amortization or balloon payments, which expose the borrower (and hence the CLO/lender) to refinancing risk. Corporate loans have covenants designed to provide the borrower with flexibility to operate an ongoing and evolving business. Indeed, the prevalence of so-called "covenant-lite" loans has taken that flexibility to a new height.

By contrast, project loans are very focused in that they involve a single asset (and generally a single "credit" associated with the asset's revenue stream) rather than a line of business. Project loan proceeds cannot be used for anything other than financing that single asset. Project loans are typically secured by all of the borrower's assets (including its equity), the most valuable assets of which are the underlying asset and the associated commercial contracts. Project loans generally amortize over the life of the loan, although there has been a trend lately (in certain industries) to have a balloon payment at the end, which inherently raises refinancing risk. Project loans are supported by a detailed covenant package that includes reserve accounts, dividend restrictions, debt service covenants, and very significant lender oversight of all operational-related aspects of the business (e.g., adherence to budgets and use of proceeds), all finely tailored to the specifics of the asset being financed. Project loans have a high level of surveillance/monitoring/reporting, generally with "independent" advisors providing frequent reports on operations and market conditions.

These differences should make project loans an extremely attractive asset class from a rating agency's perspective and from the perspective of institutional investors.

DEFAULT CHARACTERISTICS OF PROJECT LOANS

Two principal concerns drive the composition of a CLO portfolio—namely, the probability of a default and, consequently, the expected amount of a recovery following default. Although there is less certainty with respect to a default rate for project loans, it appears that project loans would provide a higher likelihood of recovery than typical corporate loans.

The default rate analysis undertaken by the rating agencies for a PF CLO is complicated and must be tailored to each individual CLO. Unlike corporate loans, there are extremely limited track records and limited statistical data surrounding the performance of project loans after a default. Correlation factors are far more diversified and complicated to determine than in the case of corporate loans. Although one would expect there to be a strong correlation between loans to two different manufacturers of, by way of example, nutritional supplements (particularly within a single country or region), there is little (if any) correlation between the project financing of a wind farm in California and a gas-fired power project in New York. Geographic correlation is also unique, particularly in the context of a global project loan portfolio. Is a default in a single industry in one country likely to be accompanied by a default in the same industry in another country? What if countries are in the same region? While a decade ago, one might find positive correlation among the various countries of Latin America or Asia, that may no longer be the case today. On the other hand, one author has questioned whether "loans to power projects in Brazil and Argentina [are] effectively diversified, given the substantial interaction between the energy sectors in these two countries."[4]

Adding to the unique features of project loans are the importance of third-party "revenue providers" whose credit generally underlies the entire project financing.

Two different projects supported by a common feedstock provider or off-taker will have a strong correlation in default, while unrelated entities in the same industry, but with different suppliers/off-takers, should have little (if any) correlation. By way of example, Petrobras is a key off-taker to a multitude of limited recourse projects in different industrial sectors in Brazil, but a breach by it in a vessel financing should have no impact on vessel financings supported by Pemex in Mexico.

The default characteristics of project loans suggest that the recovery rates following default should be higher than in the case of corporate credits. Project lenders generally structure the financings based upon conservative pro-formas that are supported by commercial contracts with creditworthy entities. The value of the project lies in its operation and never in the liquidation of its underlying assets. Although there are only limited precedents involving defaulted project loans as compared to corporate loans, one commentator has noted that "the nature of the enterprise, as well as the loan structure itself, means that default is more likely to lead to restructuring of debt rather than liquidation."[5]

The timing issues associated with a project also are key and unique to project loans. A project is far riskier to its creditors while in construction/development as opposed to during its operational phase. For this reason, PF CLOs to date have largely avoided, and those expected in the future are likely to avoid, the inclusion (in a material way) of projects prior to their completion and operation. As mentioned earlier, project loans generally amortize fully over the life of the loan and hence become less likely to default over time, while non-amortizing corporate loans behave in the opposite manner. Given step-in rights and early default triggers associated with project loans, equity pledges, liquidated damage provisions for counterparty defaults, and the like, one would expect that recoveries will be faster and greater than generally would be the case with corporate credits.

Despite any default rate uncertainty, Moody's has determined that the default characteristics of project loans argue in favor of their inclusion as an asset class for CLOs:

> We expect that the correlation between PF assets to be similar or lower than correlation between the corporate loans within the same industry sector.
>
> While most project finance borrowers are highly leveraged, thinly capitalized SPVs with limited financial flexibility, project finance loans are structured to 1) be both highly resistant to a wide range of severe risks and 2) minimize any post-default economic loss.
>
> The findings of our 2013 Default and Recovery Study suggest that the risk allocation, structured features, underwriting disciplines and incentive structures, which characterize the PF asset class, have proved effective. (Moody's Investors Service [2013]).

Given all of these positive features of project loans, why have there been relatively few PF CLOs to date and why have we yet to see their revival post credit crisis?

CHALLENGES TO SECURITIZING PROJECT LOANS

Although the corporate loan market has been moving toward greater consistency in documentation, the project loan market has been and continues to be of a highly bespoke nature, almost by definition. Project loans may involve numerous jurisdictions (e.g., the domiciles of the borrower, suppliers, off-takers, contractors, and so on) and require more complicated legal analysis than an ordinary CLO. Similarly, multiple currencies, and hence FX hedging, may be involved.[6] Each of these issues will be magnified if the PF CLO is contemplated to involve a global project loan portfolio.

Borrower consent rights to assignments are not uncommon in project loans and may pose restrictions on assignments to a CLO (note that the project loan market has been slow to adopt the concept of an "eligible fund" managed by the original lender as being a permitted assignee without borrower consent). In such an instance, a participation (i.e., a "silent" assignment of equitable interests but not legal title) may be used and can be crafted as a true sale for purposes of a rating agency's requirement that the CLO issuer be bankruptcy-remote and its assets ring-fenced. The participation must, however, be governed by the law of a state of the U.S. and not English law, because under English law, a participation creates a debtor–creditor relationship between the seller and buyer rather than a true sale.

A project loan will often have more restrictive confidentiality provisions than corporate loans and may restrict the lender (i.e., the CLO issuer) from disclosing details of the project loan to third parties (e.g., CLO investors). This may limit disclosure in an offering memorandum that investors may require. This may also limit the scope of ongoing reporting that CLO investors (and rating agencies rating the CLO) will want to receive. Much of the CLO methodology is based on ratings of the underlying assets of the CLO. Although project bonds will be subject to ongoing rating surveillance, that is not the typical case for project loans. This will require the PF CLO sponsor to either securitize a smaller universe of rated deals or obtain shadow ratings on the underlying loans, which can be expensive.

Given these factors, it goes without saying that structuring and implementing a PF CLO will be more time consuming and costly from the sponsor's perspective. From the rating agencies, to the lawyers (often of multiple jurisdictions), to the various service providers, the costs involved will likely exceed those of a more "plain vanilla" CLO. The cost may well be worth it, however, to provide balance sheet relief to a sponsoring bank.

REGULATORY HURDLES TO PF CLOs

Two post-credit-crisis events may affect any hope for revival of PF CLOs—namely, the adoption of the proposed Volcker Rule[7] in the U.S. and the risk-retention requirements for securitizations (already in place for European financial institutions and likely to be implemented in the U.S. within the next several years). The Volcker Rule, which would implement Section 619 of the Dodd–Frank Act and has been jointly proposed by five federal regulators, essentially restricts U.S. banks and foreign banks with U.S. branches or subsidiaries from sponsoring or investing in private funds (being defined as funds that rely on Section 3(a)(i) [i.e., fewer than 100 investors] or 3(c)(7) [i.e., all investors are "qualified purchasers"] of the Investment Company Act of 1940). Most CLOs to date have been structured as 3(c)(1) or 3(c)(7) funds and hence fall under the Volcker Rule. The regulations to implement the Volcker Rule have not yet been finalized, and there is some language in the Dodd–Frank Act that would argue that loan securitizations are not intended to be restricted by the principal investment restrictions. It may also be the case that PF CLOs can be structured so as to be exempt from the purview of the Volcker Rule to the extent they can be structured to comply with Rule 3a-7 of the Investment Company Act (which would not be deemed a "private fund" per se under the Volcker Rule), which should be workable in the context of a balance sheet CLO of a relatively static portfolio and even allow for reinvestment of defaulted assets.[8]

The European community has already implemented, and the U.S. will implement in as soon as two years, risk-retention requirements that will require a sponsor or securitizer to maintain "skin in the game" of 5% of the capital structure of the securitization. This should not pose a problem for a bank sponsor of a PF CLO, although it presents an interesting Catch-22. The Volcker Rule prohibits a bank from holding more than a de minimis portion of any covered fund, which is limited to 3%. One possible solution here would be for the sponsoring bank to hold its retention at the level of the project loan itself rather than through the capital of the PF CLO. We also would hope that the final Volcker Rule will recognize this problem and exempt positions in covered funds required to be held pursuant to the risk-retention requirements.

REASONS FOR OPTIMISM

Numerous factors argue in favor of the comeback of the PF CLO:

- CLOs have recovered following the credit crisis and middle market and more non-plain-vanilla CLOs are being sponsored.
- Emerging market loans are finding their way into CLO portfolios.
- There is a demand for new CLO eligible assets to fuel the surge in issuances and a dearth of new corporate loan issuance.
- Infrastructure needs are growing rapidly, governments are pushing for funding by the private sector, and commercial banks face hurdles for additional funding.
- Non-bank investors have a strong appetite for project loans and don't face all of the regulatory hurdles confronting banks.
- Project loans have attractive characteristics from a ratings perspective.

Most importantly, CLOs have provided a gateway for non-traditional lenders to enter the project loan space. It permits institutional investors that may require rated paper and that will only invest in a diversified portfolio to provide an alternative source of funding for projects. Although there are numerous regulatory uncertainties surrounding the CLO market, with careful planning, the CLO remains an attractive structure for monetizing project loan assets and for bringing a broad range of capital market investors to fill the gap that otherwise would exist in the financing of infrastructure assets.

ENDNOTES

[1]CreditFlux (www.creditflux.com), September 16, 2013.

[2]A recent article reported that CAF (a multilateral Latin American development bank) plans to sponsor a collateralized debt vehicle principally to fund Colombian road projects (Llanos-Small [2013]). Separately, Class A-1 notes issued by Adriana Infrastructure CLO 2008-1 B.V. were upgraded by Moody's on September 25, 2013, following a restructuring (from A3(sf) to Aaa (sf)).

[3]Examples of PF CLOs to date include Adriana Infrastructure CLO 2008-1 B.V., Bacchus 2008-2 plc, Boadilla Project Finance CLO (2009-1) Limited, TCW Global Project Fund III, Essential Public Infrastructure Capital II GMBH, and SMART PFI 2007 GMBH. Prospectuses describing these financings can be obtained on the Irish Stock Exchange website.

[4]Forrester, P. "Project Finance CDOs After the Credit Crisis." *Infrastructure Journal*, August 25, 2010.

[5]Tanna, K., and M. Choudry. YieldCurve.com. "Market Interaction and The Project Finance Collateralised Debt Obligation." Published in the Euromoney Syndicated Lending Handbook, 2004.

[6]Note that recently enacted regulations under the Dodd–Frank Act could subject a PF CLO engaged in any material hedging to register with the CFTC as a commodity pool operator.

[7]See www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf.

[8]Rule 3a-7 provides an exemption from investment company act registration for an issuer of asset-backed securities that does not acquire or dispose of assets "for the primary purpose of recognizing gains or decreasing losses resulting from market value changes." While this exemption would not be available for an actively managed arbitrage CLO, it could work for a static balance sheet CLO.

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