

The prudent choice

Managers at Pramerica Fixed Income believe it has the scale and track record needed to secure replacement mandates. By *Mike Peterson*

Plenty of firms argue that they are well placed to act as CLO consolidators. But in this relatively youthful business, not many can point to a long history of acquiring deals from defunct and rejected managers.

Pramerica Fixed Income Management, part of US life insurance giant, Prudential Financial, Inc, is one manager with a track record as a consolidator. (Prudential Financial, Inc. is incorporated and has its principal place of business in the USA, and is not affiliated in any manner with Prudential Corporation plc, a company incorporated in the UK.)

Pramerica began taking over other managers' deals right after the first wave of CBOs began to hit problems at the turn of the century.

"In the late 1990s there was an explosion in the number of shops that were issuing CBOs," says Paul Appleby, the head of the unit's leveraged finance team. "Many of these managers were pretty small – of the two-analysts-and-a-Bloomberg variety. And in the last crisis, between 2000 and 2001, a lot of these CBOs got into trouble. We picked up eight mandates between 2001 and 2004."

Pramerica's fixed income group has a large credit business outside CDOs. Of its \$227 billion of fixed income under management, there are over \$7 billion in leveraged loans and \$11 billion of high yield bonds as of 30 September 2009. The high yield bonds are spread fairly evenly between institutional funds, retail mutual funds and proprietary investments on behalf of

the insurance company parent, with a small amount held in the CDOs. In high yield loans the mix is very different, with the majority of loans managed through CLOs.

Pramerica also manages some hedge fund strategies, including emerging markets long-short and liquid products relative value strategies, and a credit opportunity fund.

A total of 17 CDOs which Pramerica has managed since inception remain outstanding. Four of its original deals, Dryden I to Dryden IV, have since been called, with many investors rolling into new transactions. Besides its Dryden series of CLOs, transactions include two balance sheet CLOs and two CSOs. Typically, Pramerica has invested in the equity of the Dryden deals.

At a glance

Name Pramerica Fixed Income Management

Headquarters Newark, New Jersey

High yield bond and loan assets under management \$18 billion

CLOs Dryden V, Dryden VI, Dryden VII, Dryden VIII, Dryden IX, Dryden X, Dryden XI, Dryden XIV, Dryden XV, Dryden XVI, Dryden XVIII, Dryden XXI

Synthetic CLOs Dryden XII, Dryden XVII

Replacement manager CDOs BEA CBO 1998-1, FC CBO II, FC CBO III, FC CBO IV, ML CBO XIV, Gateway CLO

Other CDOs Euro Atlantis CLO, Concorde CLO I, Prudential Structured Finance CBO I

Besides these deals, it also has the mandate to manage six CDOs that were originally launched by other managers. And the firm added to its tally of replacement manager mandates in October when it took over Duane Street V CLO, a \$490 million CLO dating from 2007. The deal, which was originally managed by DiMaio Ahmad Capital, has been renamed Gateway CLO.

All told, the group manages 23 CDOs, one of the biggest tallies in the market. And Sara Bonesteel, Pramerica Fixed Income Management's head of alternative products, firmly believes that size provides one of the Pramerica's biggest competitive advantages when it comes to taking over other deals.

"We have a very extensive infrastructure to do replacement manager business," Bonesteel says. "We think we are a natural alternative for investors who are concerned about being invested with a smaller shop, which perhaps has difficulties in terms of credit coverage and operations."

Like other large high yield managers, Pramerica can make the argument that the scale it achieved through managing retail and institutional products give it a big advantage over firms that earn all their fees from structured credit vehicles.

"A shop that manages a few CLOs and nothing else will find it impossible to maintain a full credit research group if its subordinated fees are cut off," says Appleby. "We have a critical mass of deals, so we can maintain the infrastructure that we believe is critically important in difficult times like these. We have 25

credit analysts – senior and junior – supporting our leveraged finance business, so we can do credit analysis that smaller shops can't."

Having a large credit research team has not enabled Pramerica to escape the problems suffered by the CLO business as a whole amid the recent sharp increase in high yield default, lower loan prices, and



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weaker than expected recoveries.

But Pramerica hopes that superior credit analysis will pay off in the long term as it avoids credits that cause problems in future. The firm also believes that its approach to managing CLOs, while not always designed to wring the last drop of juice from the CLO structure, is one that will provide better returns to investors over time.

"Some managers let ratings and the metrics of the CLOs dominate their investment decisions," says Appleby. "But we turn the process around the other way. Our primary consideration is the total return of the portfolio. We want to be sure that we are buying the loans that offer the best value relative to the universe of loans available to us."

He points to the example of Pramerica's first Dryden CDO, which avoided the downgrades of many of its contemporaries. It was eventually redeemed in 2007 after paying equity investors an internal rate of

return in excess of 30%, according to Appleby. Other high yield CBOs, by contrast, were hit by much higher than expected defaults.

"You can put together a CDO that optimises all the metrics," he says. "On the surface it may look like a great portfolio, but if the economy deteriorates it won't perform well, especially for equity investors."

Something else that has lowered a key metric for Pramerica's CLOs is the manager's willingness to sell out of deteriorating credits. If a CLO sells an asset below par, this loss is realised in its overcollateralisation or par value ratio. This means that in a deteriorating credit environment, a defensive strategy inevitably results in a falling par value, while a less cautious manager who gets lucky and sees the credit survive, will enjoy a higher par value.

But Pramerica believes that this finger-crossing strategy is a mistake. "One real danger in managing to the metrics in CLOs and CBOs is that you hang on too long to a credit because you don't want to take the hit," says Appleby. "If you bought a credit at par and you find that it is at 70, the tendency is to hold it. But before you know it, the credit may be at 30 cents and you have a default situation." Pramerica, by contrast, has been quick to sell deteriorating loans.

Appleby's portfolio management team includes Joe Lemanowicz, who runs the US loan deals along with a more junior portfolio manager. Similarly, Jonathan Butler is the senior of two portfolio managers for European loans. The team can also draw on the expertise of Pramerica's high yield portfolio managers, given the overlap of names between the leveraged loan and high yield bond markets.

The research team consists of 16 senior analysts and nine junior analysts. In addition, there is a group of four dedicated CDO analysts.

While the new issue CLO business has been dormant for the best part of two years, Pramerica sees it coming back and expects to add to its tally of new deals in future.

Bonesteel believes that with spreads on secondary CLO senior paper having rallied substantially this year, there will be demand for senior notes paying perhaps 150 basis points over Libor. "The challenge that remains is finding a home for the equity, especially since it will be less geared than a couple of years ago," she says.

However, replacement mandates rather than new deals are likely to be Pramerica's main path of growth in the CLO business in the immediate future.

"The one change we have seen in the last three or four months is that subordinated fees have been cut



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Paul Appleby

off in a lot of deals," says Appleby. "That has changed the economics for managers, and some are looking to sell the business. They are not giving those deals away, but they are increasingly starting to reconsider whether it makes sense to be in this business."

Pramerica, with its \$11 billion of cashflow CLOs under management (as of 30 September 2009) under the Dryden programme alone, clearly sees itself as being in the business for the long term.