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Wall Street's Billionaire Machine, Where Almost Everyone Gets Rich

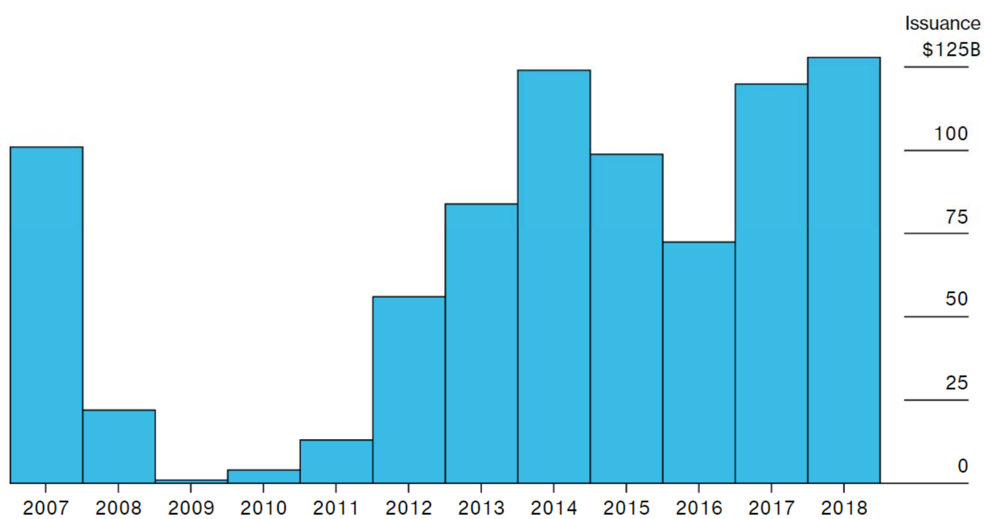
By Tom Metcalf, Tom Maloney, Sally Bakewell and Christopher Cannon

He has the familiar trappings of the ultra-wealthy: a Beverly Hills estate, a superyacht, art by Rothko and Pollock.

But Eric Smidt is a new kind of super-rich. He made his fortune by transforming an old-fashioned business into a giant ATM, an overhaul aided by one of the hottest plays on Wall Street: collateralized loan obligations.

Meet the new aristocrats of debt—the people and companies cashing in on a record boom in these once-marginal investments whose relatively high returns have attracted yield-hungry investors. They've fueled a rapid buildup in corporate debt that some think could become the epicenter of the next credit crisis but has been minting money for many.

Record Volume
CLO sales hit all-time high in 2018



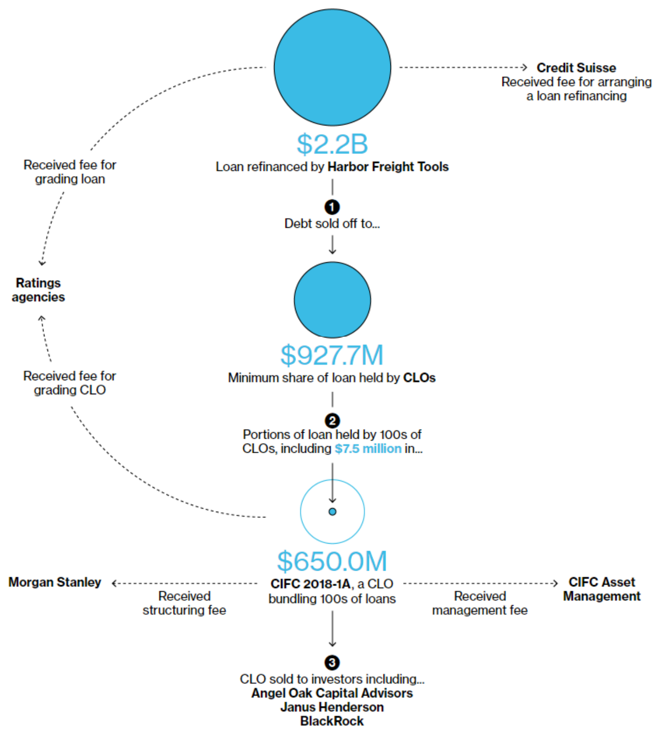
Source: Wells Fargo, Bloomberg
Note: Volume does not include reissues; 2018 is year to December 18.

From low-profile executives like Smidt to prominent banks like Credit Suisse Group AG, a host of players are getting rich off CLOs. Fees linked to the industry topped $10 billion this year alone, according to calculations by Bloomberg. That's in addition to billions in payouts that private equity and other owners have extracted from businesses.

Some, like Credit Suisse, get paid for underwriting loans to companies such as Smidt's Harbor Freight Tools USA. Because CLOs are really a package of risky loans from various businesses like Harbor Freight, a bank like Morgan Stanley also scores a fee for structuring the parcel and then selling it to investors.

That bundle of debt also needs an overseer. Enter CLO managers such as private equity firm Ares Management, co-founded by billionaire Tony Ressler, and GSO, part of billionaire Stephen Schwarzman's Blackstone Group LP. They get a cut, too.

A Peek Inside the CLO Factory
Tool retailer Harbor Freight Tools refinanced a $2.2 billion loan this year. Much of it ended up in hundreds of CLOs, or collateralized loan obligations.



Source: Bloomberg

Regulators globally are sounding alarms. For the Bank of England's Mark Carney, the surge is reminiscent of the boom in subprime lending just before the financial crisis in 2008. Some members of the Federal Reserve are concerned that high debt levels are making the economy more vulnerable.

"The risk is that if a bunch of these get downgraded, many CLOs will scramble to sell," said Gene Tannuzzo, a fund manager and deputy global head of fixed income at Columbia Threadneedle Investments.

In recent weeks, there have been increasing signs the machine is sputtering as volatility swirls through markets. Loan prices have fallen to the lowest in more than two years. Deals are increasingly being shelved or pushed to next year, a far cry from the demand seen earlier in the year when Harbor Freight's loan was priced.

Here are the key players and what's at stake.

The Debtors: $1.3 Trillion

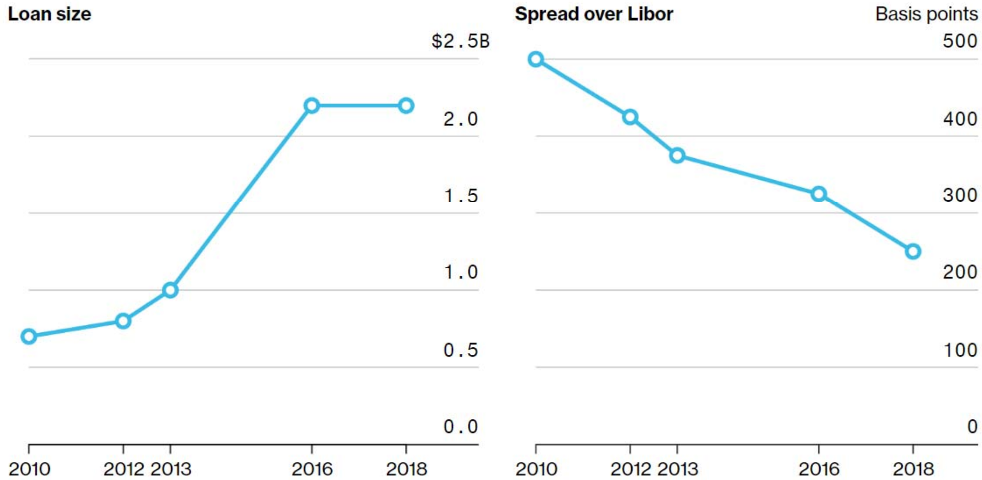
Harbor Freight—which sells discount tools such as $7.99 wrenches and $8.99 pliers sets—has tapped the debt market five times since 2010, raising $6.8 billion, including refinancings, and has paid about $2 billion of dividends, according to Bloomberg calculations. The company declined to comment, as did Smidt.

That's just a fraction of the market. Corporate owners loaded a combined $1.3 trillion in loans onto their books this year, enabling them to raise greater amounts of capital at lower rates over the past decade. About $40 billion worth of leveraged loan deals this year had dividends as one of the stated uses of the proceeds.

The market has helped bolster the wealth of business owners like Smidt, who's worth about $3 billion, according to the Bloomberg Billionaires Index.

There's plenty of others. Startup AppLovin, which operates a mobile ad platform, issued an $820 million leveraged loan in July. Beauty firm Anastasia Beverly Hills sought a $650 million loan to help fund a partial buyout by TPG Capital.

Cheap Loans
The cost of Harbor Freight's debt has been falling



Source: Bloomberg

Lender Fees: $6 Billion

When Harbor Freight went to the market to refinance in January, investors were drooling. The company got $2.16 billion—fully funded just eight days after it was announced.

As lead lender in the deal, Credit Suisse would have scored the bulk of any fees for underwriting the loan. The bank declined to comment.

The fees collected would have been even higher for a brand new loan issued. Lenders can charge about 2 percent of the issuance, generating at least $6 billion for them in 2018, according to calculations by Bloomberg. While Credit Suisse reaped some of those profits, it's only the sixth-largest player in the U.S. leveraged-loan market, underwriting about half the volume of leaders Bank of America Corp. and JPMorgan Chase & Co.

Management Fees: $2 Billion

The Harbor Freight loan has made its way into hundreds of separate CLOs with the biggest holder being funds managed by Ares, the Los Angeles-based firm with a history of generating wealth through private credit.

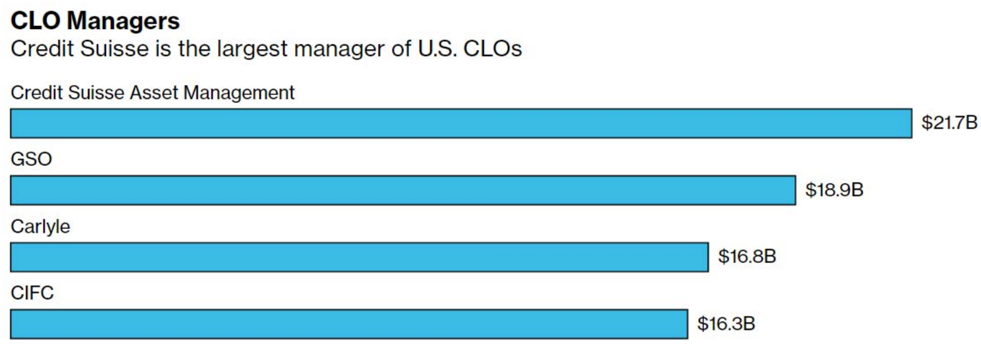
As with the banks who underwrite the loans, fees paid to CLO managers like Ares can mount. Larger CLO managers generally charge between 30-to-50 basis points on the assets they manage. Ares declined to comment.

The amount of outstanding CLOs in the U.S. market totaled about $600 billion as of December, according to data compiled by Bloomberg. That means the industry's combined management fees would be about $2 billion this year. Other industry players that grabbed slugs of the Harbor Freight loan included CIFC Asset Management and hedge fund firm Och-Ziff Capital Management Group LLC.

Structuring Fees: $2.8 Billion

Once these managers offer the CLOs to investors, Wall Street takes another cut. Morgan Stanley, for example, was one of the banks involved at this juncture as the Harbor Freight debt moved through the market this year. It structured a $650 million CLO managed by CIFC. The CLO bought $7.5 million of the Harbor Freight paper and still owns a $4.6 million slice of the debt.

CLO structuring fees hit a record $2.8 billion in 2018, up from $2.1 billion last year and $671 million in 2016, according to estimates by Freeman Consulting Services. Morgan Stanley was also responsible for selling the CLO that included the Harbor Freight loan to investors like BlackRock Inc., Janus Henderson Group PLC or Southern Farm Bureau Life Insurance. Morgan Stanley didn't respond to a request for comment.



Source: Bloomberg

The Investors: 20% Yield

Yield-hungry investors have been eager to invest in CLOs, helping to fuel the market. Returns on the riskiest equity piece can stretch to 20 percent. While those gains suffered this year, they still stand out in credit markets where corporate bonds have delivered little or negative returns.

Appetite is such that even traditionally conservative investors have increased their exposure. The Canada Pension Plan Investment Board said in September that it would invest in the riskiest tranches of CLOs, putting $285 million into an investment vehicle that will buy equity tranches. Advantage Insurance of San Juan, Puerto Rico, has also been investing in the equity.

CLOs invest in corporate loans with floating rates rather than fixed ones. That means, unlike normal bonds, they can benefit when interest rates rise.

Warning Signs

Amid all this exuberance, there are signs of overheating in the leveraged loans that underpin the CLO market. For one, the majority of loans have long been “cov-lite,” meaning they have fewer of the protections investors typically demanded to shield themselves from an issuer defaulting.

On top of that, borrowers pushed the envelope on other terms that may harm investor recoveries. They’ve added facilities that layer extra debt on existing loans and adjusted earnings calculations, which could overstate a firm’s ability to repay.

In recent weeks, jitters in global markets have shifted the rosy outlook for CLOs. Some loan deals have been scrapped as investors become more wary of lending to companies with mountains of debt.

Industry players shrug off criticism, saying CLO deals held up well through the last crisis. But others say this time will be different because of the level of debt on companies rather than consumers.

Smidt’s own father, who died in 2016, raised the alarm long ago. He criticized the practice of borrowing to extract cash from the family business in a 2010 lawsuit filed after he sold his interest in the company to his son. But Smidt—who denied the allegations and settled the case out of court—forged ahead, adding debt and spearheading a nationwide expansion of the retailer, propelling its revenue north of $4 billion this year from $2.4 billion in 2013, according to Moody’s Investors Service.

And there’s little sign the family’s discount-tool business, or Smidt’s fortune, is under stress. In February, he and his wife Susan donated $50 million to a heart institute at Cedars-Sinai hospital in Los Angeles that now bears their name.

Lloyd Greif, founder and chief executive officer of Los Angeles-based investment bank Greif & Co., sees few dark clouds on the horizon for Smidt because the company’s bargain-basement prices mean it should prosper even in a recession.

“Lenders line up to write a check to him,” Greif said. Others may be more at risk.

"But it can be a double-edged sword for companies with business models more susceptible to recession risk. That’s why I call it the magic and misery of leverage."