Insurance assurance

Christopher Freeze, senior md and head of investor relations at Churchill Asset Management, answers SCI's questions

Q: Churchill closed its inaugural collateralised fund obligation (CFO) last month. The US$700m transaction will invest across the firm's flagship private capital fund strategies. What were the drivers behind the launch of the deal?
A: At Churchill, we are a solutions-oriented firm solving for investor needs. We asked ourselves: how can we introduce insurance company investors to the full array of our flagship investment strategies in a way that truly works for them?

In the US, insurance companies are heavily regulated and have regulatory capital challenges related to investing in certain types of private funds. We sought to find a way for them to access our core private capital strategies, where the capital charges were otherwise prohibitive.

The CFO structure we created essentially combined the best of Churchill. It has a meaningful private credit allocation that is paying a cash yield immediately, as well as a substantial allocation to private equity assets that generate longer-term returns. The blend was a unique offering that fortunately happens to benefit from the nature of our platform.

Ultimately, we had a lot of great conversations with insurance companies who found it interesting. Investors also appreciated that we are indirectly owned by a Fortune 100 insurance company, TIAA, which showed a lot of alignment as well.

Many of the approximately 25 investors we spoke to were already invested in or were looking at similar structures. I believe the asset class will continue to grow, as top asset managers - like Churchill - try to find ways to better engage with insurance companies and help meet their needs.

Q: Could you provide more details on the collateral backing the CFO?
A: Churchill's CFO is comprised of a pool of existing private equity assets, as well as commitments to the four flagship strategies we offer. We allocated a portion to our senior lending strategy, which is a more conservative mandate with a low loss rate over our 16-year history. Another portion was allocated to our junior capital strategy, which has a slightly higher return profile. The remainder was invested in our two private equity strategies – US middle market private equity fund commitments and US middle market co-investments.

Q: What are the innovative aspects of the deal's structure?
A: CFOs are relatively new, and people still have a lot of questions about them. We expected that more risk-adverse insurance companies would gravitate to a more conservative offering, so we tried to appeal directly to that group of investors with a healthy mix of two different kinds of asset classes.

We did not ask investors to invest in any untested strategies. Each of the asset classes that the CFO invests in are core strategies of Churchill. Additionally, as many CFOs have very long investment periods, we committed all the capital to those core strategies as soon as possible following closing, so that investors know exactly what exposure they are getting.

We also tried to deliver something that was highly diverse. We hope that our CFO will ultimately have exposure to 750 or more underlying investments – if that is achieved, it will be one of the most diversified investment structures out there.

We believe this offers comfort to insurance companies, who are debtholders in the structure and should allow them to feel good about things working out well. Of course, it's operationally intensive, given the number of investment positions – but we have the right infrastructure in place and believe it's well worth the benefit.

Q: Does this deal open the door for CFOs to be increasingly backed by private credit exposures rather than predominantly private equity commitments?
A: I think you could see more private credit CFO structures come to market because of the underlying nature of credit instruments. The biggest initial challenge for CFO issuers is figuring out how you pay the coupon and mitigate effects of the j-curve, and private credit investments have strong, consistent cashflows that can do just that.

While investors likely have to give up a little of total return in such a transaction, it's ultimately very attractive to have these types of cashflow assets paying the coupon early on in the life of the transaction. This is what made Churchill's CFO innovative and different, and could lead the way for other managers who previously may not have thought about using credit in this way. However, it does require having a senior lending or junior capital strategy that insurance companies are comfortable having exposure to, because ultimately they have to believe in your capability to deliver.

Q: What are the prospects for the CFO market going forward and what do you hope Churchill's role will be in it?
A: I think the market will continue to grow, but the barriers to entry are still very high. That's why the successful managers in this space are predominantly large-scale managers, with strong track records and diversified strategies that investors want to access.

Put yourself in an investor's shoes. You can invest in a single-name fixed income asset and receive a certain yield.

Alternatively, you can invest in a CLO and get that same yield, plus an additional premium, but with a more highly diversified credit exposure. Or, you can invest in a CFO and get a substantially higher yield enhancement, with many of the same protections as found in a CLO structure. Now, more than ever, investors are looking for ways to create additional returns - and if a CFO structure can help meet their objectives, it's a very attractive option.

Churchill continues to think about opportunities to offer transactions in this space, with different structural options based on investor feedback we've received. Certain insurance companies, for instance, are interested in long-dated structures, as they have long-dated obligations (e.g. life insurance). Others, however, want the opposite, and are looking for a credit-oriented structure as a result. Ultimately, we are contemplating different approaches that can address these goals – and it's pretty exciting.

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