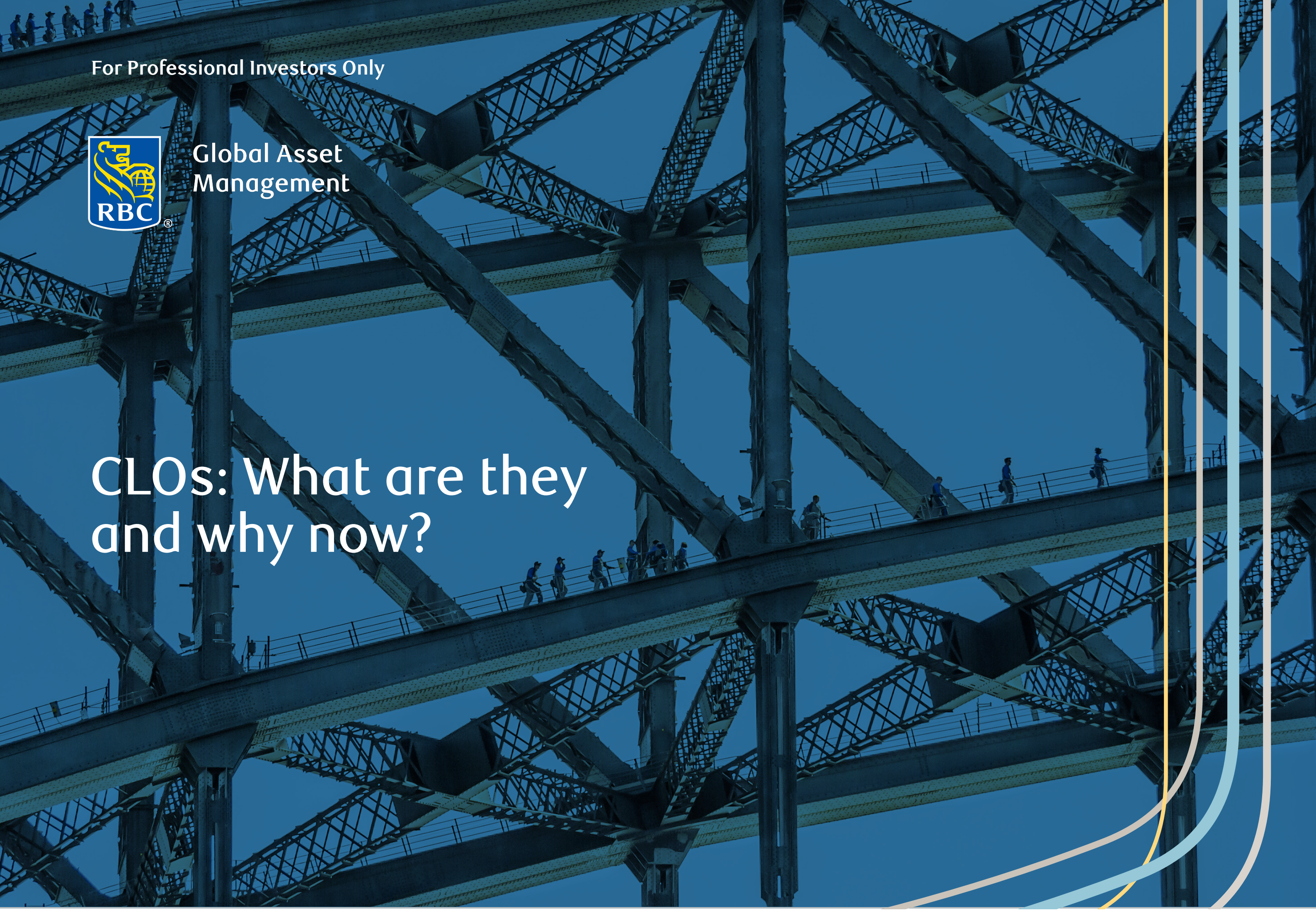

For Professional Investors Only

Global Asset Management

CLOs: What are they and why now?

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With the asset class breaching the USD1 trillion mark in 2021, demand for CLOs continues. Find out more about these floating-rate instruments, what differentiates them from other securitised products and how they are likely to perform in today's volatile market environment.

What is a CLO?

CLO stands for collateralised loan obligation. It is a type of securitisation transaction in which a pool of leveraged loans is aggregated to form the collateral. Cashflows from those loans provide interest and principal payments to investors in the CLO vehicle.

The assets in a CLO are typically broadly syndicated below investment-grade floating rate first lien loans that sit atop a company's capital structure, although some CLOs have flexibility to add second lien loans or fixed rate notes such as bonds.

Investing in a CLO is another way to access the loan market, but the real appeal for investors is that the CLO has a number of different tranches that vary in risk and return profile.

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How do the debt tranches work?

CLOs are structured with a number of debt tranches – typically rated AAA down to single-B, as well as an equity tranche. Interest or principal payments are made first to the most senior bonds and residual interest cash flow, if available, can be passed to the equity tranche. Conversely, losses in the collateral pool of loans are first absorbed by the most junior tranches, meaning the equity tranche would receive first losses.

The AAA-bond is the most senior part of the capital structure and sits at the top of the priority of payments waterfall. The AAA bond offers the lowest coupon, but it is the most liquid and the most remote from default risk.

Most AAA CLOs are structured with 35%-40% credit enhancement, which means that nearly half of the collateral pool would have to default at a 0% recovery rate for a AAA bond to take a principal loss. Due to other structural protections in the deal, the amount of collateral losses would need to be substantially higher than that for a AAA bond to take a loss.

Contrastingly, a BB bond is further down in the capital structure, lower down in the priority of payments and more exposed to default risk. However, investors are compensated for this risk with a much higher spread and total return.

Even at the BB and B level, tranches are structured with 6-10% credit enhancement so they are relatively well insulated from credit risk given their structural protections and deals' diversified collateral pools.

"The AAA bond will offer the lowest coupon, but it is the most liquid and as the lowest risk part of the structure it is most remote from default risk."

What differentiates a CLO from other securitised products?

The main difference is that CLOs are actively managed by an asset manager versus other securitised products that have an asset pool that is static in nature. CLOs typically have a reinvestment period of five years, during which the asset manager can trade or reinvest principal repayments into new loans. The reinvestment period can be fairly powerful, particularly during a period of market dislocation.

How big is the CLO market and what are the issuance expectations for this year?

The market has matured and grown over the past decade. In 2021, it passed the USD1 trillion mark—with around 80% in the US and 20% in Europe.

Every year the market sees additional participants and new types of investors attracted to what the asset class has to offer, so we expect growth to continue.

We saw record-breaking issuance in 2021, with USD187bn in the US – 2x the issuance seen in 2020 and 1.5x 2019 issuance. Europe saw EUR45bn of issuance in 2021 vs. EUR25bn in 2020 and EUR33bn in 2019. Both regions benefited from elevated asset spreads, low cost of capital and a plethora of deals that were ripe for refinancing or reset opportunities following the pandemic.

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What’s performance been like so far in 2022?

The primary market got off to a slower start to the year given the Libor-SOFR transition in the US and other macro volatility, which has added some uncertainty to spreads.

We’re currently seeing elevated geopolitical concerns, but ultimately, we think things will calm down and CLO issuance will be robust in 2022 given that CLO equity investors have found ways to make the arbitrage work and floating-rate assets, both in the loan space and CLO tranche space, are in demand.

We believe this will continue to be the case as the Federal Reserve and European Central Bank have clearly laid out their hawkish intentions.

Investor appetite remains robust for the CLO market; continued demand should lead to further issuance.

In the secondary market, CLO spreads have leaked wider over the last few weeks given broader macro concerns. CLO secondary prices are a few points off the January highs, depending on the part of the capital stack and bond quality, but we believe that these can be good buying opportunities and continue to look cautiously and carefully at deploying capital here.

“On the secondary side of things, CLO spreads have leaked wider over the last few weeks given broader macro concerns.”

Why are CLOs attractive in the current market environment?

There are several factors that we believe make CLOs attractive for investors.

The first is that these assets are floating rate and therefore partially offset rising interest rates, in contrast to fixed income instruments.

Second, the relative value between CLOs and similarly rated corporates is attractive. For example, BBB US CLOs currently have a spread in secondary markets of 325-375bps vs. BBB US corporates at 155bps. In our view, this spread premium is more than compensating investors for the credit risk taken in CLO tranches, particularly given some of the aforementioned structural and collateral protections.

We sometimes say that CLO investors are essentially being paid a “name premium” since they are actually more shielded from credit risk than their corporate counterparts are; “CLO” sounds like “CDO” and this scares some people off, but they are absolutely not the same thing.

For senior investment grade-rated CLO bonds, the weighted average life (or spread duration) is typically shorter than that of investment grade-rated corporates. This is important since in periods of market volatility, shorter spread duration assets will have less mark-to-market volatility.

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How are the fundamentals?

Fundamentals are also positive for CLOs as loan defaults are forecasted to remain at low levels given companies’ relatively healthy cash balances, leverage levels, and limited near-term maturities. The backdrop of low default rates and rising interest rates creates a supportive backdrop for CLOs.

What do you see as the biggest risk for the asset class?

In our view, the biggest risk for the CLO market would be a large risk-off credit event coupled with idiosyncratic credit issues, particularly for secular decliners, perhaps due to a tightening or slowing economy. This would cross interest rate risk with credit risk. Most of the weakness seen in credit in the early part of 2022 was driven by inflation concerns and rising rates. As such, the CLO market was fairly robust; in fact, it held up remarkably well versus almost all other asset classes given the demand for floating-rate paper and record retail loan inflows in the US.

With macroeconomic and geopolitical issues dominating the headlines, CLO structures are now being tested again as they were during the global financial crisis, European sovereign debt crisis and the Covid-19 pandemic. Their successful weathering of these unprecedented events is another reason why we believe we'll continue to see new investors attracted to the asset class.

Fundamentally, we believe CLOs are robust vehicles that have been tried and tested through various cycles – in fact, no US or Euro AAA or AA-rated CLO tranche has ever taken a dollar of impairment and only one US A-rated tranche has ever seen an impairment. But ultimately, CLOs are risk assets and during large disruptions risk assets tend to become more correlated and liquidity becomes more challenging to find, even for "money good" investments.

But overall, we think CLOs can withstand current, and additional, risk-off events and we always look to buy into weakness because of the potential opportunities that CLOs can provide.

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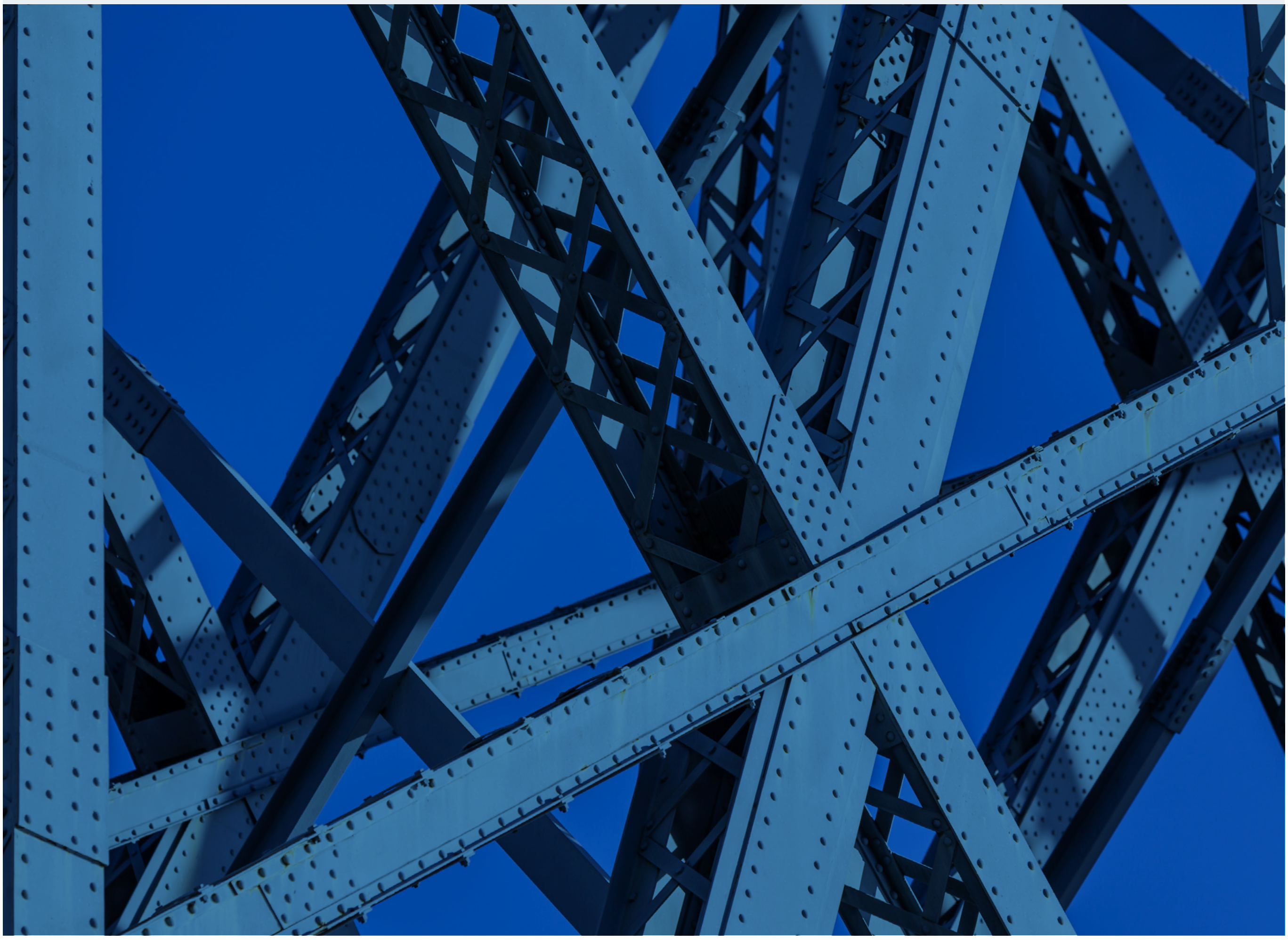

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